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Jeffrey Friedman

GLOBALIZATION, NEITHER EVIL NOR INEVITABLE

Do we really need to hear more about globalization? Like it or not, we will: both Left and Right justifiably see it as the early twenty-first century's locus of political alignment. The multinational corporations and international agencies that organize global trade and investment have replaced the bourgeoisie as the objects of anticapitalist derision; contempt for free traders is emerging as the dominant feeling on the young and restless left. On the right, disdain for the "hypocrisy" of antiglobal protestors—who smash the windows of Starbucks while clad in clothing by the Gap—has replaced revulsion against Communists who, during the Cold War, used the freedoms of the West to undermine democratic capitalism. And then there are the economistic supporters of globalization, so confident that "quicksilver capital" and the logic of gains from trade make globalization inevitable that they see resistance as futile and the debate over globalization as irrelevant.

This issue of *Critical Review* deals first with the inevitabilist thesis. It is striking that, as public-choice theory has gained ground on the right, it has served to keep alive the deterministic spirit of none other than Karl Marx. Like Marx, public-choice theorists reduce politics to economics; and in that spirit, it is now a right-wing commonplace that the progress of global capitalism is unstoppable. Likewise, many on the left have recovered sufficiently from the shock of 1989 to

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begin hailing Marx's own inevitabilism as evidence of his continued relevance: did not *The Communist Manifesto* presciently note the relentless cosmopolitanism that, a century and a half later, we call "globalization"?

It took no special insight into the future, however, to see what Marx saw. As Barry Eichengreen, Douglas Irwin, Deepak Lal, and Charles Wolf note in these pages, globalization was already a massive, unmistakeable fact in the nineteenth century. Lal even has a name for nineteenth-century global capitalism—the "first liberal international economic order"—against which he contrasts the second "LIEO."

Distinguishing the two LIEOs is crucial, because it draws our attention to something both latter-day admirers of Marx and economistic free-marketeers tend to ignore: the interregnum between the LIEOs. In that period occurred the two world wars and the Great Depression. These were not inevitabilities, any more than were the periods of relatively free international trade and finance that bracketed them. The interregnum was brought on by *politics*: the politics of imperial grandeur, of nationalist protectionism, of interventionist economics, and of antipathy to liberal democracy. These political tendencies culminated in policies and events that smothered the first LIEO.

The commencement of the second LIEO at Bretton Woods, and its continuation in the form of GATT, NAFTA, and—as Jason Sorens demonstrates below—domestic economic deregulation were also political; no economic forces made them inevitable. But the politics that shaped the second LIEO was different than the politics that ended the first one. Imperialism, protectionism, interventionism, and war were truly democratic, in that they appealed to popular passions and misconceptions. The politics of the second LIEO, in contrast, was democratic in name only. Like the now-emerging European megastate, the postwar regime of semifree trade was created by the decisions of political elites who, while democratically elected, pursued a course that would surely have been rejected—had it been noticed in the first place—by the electorates to whom the decision makers were legally accountable.

Democracy vs. the Third World

The economic nationalism of a Hitler or a Peron, or a Perot, always tends to be more popular than the internationalism of an Adam

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Smith. In the public mind, economic nationalism seems both more logical than internationalism and more just.

As a matter of logic, the threat that "our" farmers face from "foreign" agriculture, and that "our" workers face from foreign industry, and that "our" economy faces from financial speculators, are compelling because they are tangible and their victims are identifiable. The gains to "our" consumers from foreign trade and global finance are far more amorphous. A large aggregation of small increments of cheaper and better goods and services that are, to begin with, difficult to identify as stemming from free trade is unlikely to be as moving as a single news story about a textile factory shut down by foreign imports. How easy is it to see that the now-unemployed workers of that factory may well gain better jobs in industries that are made possible by the wealth no longer devoted to the less efficiently produced goods they formerly manufactured? The gain in the standard of living thereby made available to those workers' fellow citizens, too, is politically weightless.

For like reasons, attempts to penetrate the brain-numbing thicket of international-finance theory do not, in the political arena, get far enough to make clear the role financial markets play in distributing risk across places and times. And political discussions of currency policy are routinely reduced to simplistic invocations of the tangible benefits of weak currencies, which temporarily boost domestic employment by making "our" goods cheaper abroad.

Such calculations, morever, as difficult as they are to make accurately, take it for granted normatively that the just criterion by which to judge economic policy *is* domestic employment. The fact that globalization subjects First-World employees to competition against low Third-World wages makes a potent political argument, not only because it is easy to grasp, but because of its implicit grounding in nationalism—which attaches such a high value to the well-being of one's conationals that the well-being of "foreigners" barely registers at all. "Us versus them" is the easiest heuristic we have for deciding what to do, in the public as in the private sphere; the loss of "our" jobs to "them"—exemplified in the U.S. debate over NAFTA by the "giant sucking sound" Ross Perot heard emanating from Mexico—usually counts as enough to condemn free trade.

Suppose that the worst case is true: that the net effect of competition from the Third World is to reduce the well-being of the First World, because it subjects unskilled First-World workers to perma-

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nent unemployment; and because the higher standards of living delivered to First-World consumers by imports of foreign-made goods do not really matter, because happiness is not enhanced by gains in wealth above a certain minimum (see, e.g., Lane 1991, Scitovsky 1992, and *Critical Review* 1996b). It would then make sense to oppose globalization—but only if we leave out of the picture the wealth that globalization produces for the billions of people in the Third World who are below the hedonic minimum, and who are every bit as human as are residents of the First World who are lucky enough to be above it.

The reason the effects of economic policy on "foreigners" are almost never considered in democratic politics is probably not just that noncitizens, by definition, do not vote in any given polity's elections. It has been shown time and again that voters are usually "sociotropic," aiming not at their self-interest but at the public good (e.g., Lewin 1991, ch. 2; *Critical Review* 1996a). The "public" in question, however, is always defined in subglobal terms: it excludes those who happen to live beyond the borders of one's nation-state—out in the featureless world beyond the edges of the national weather map, where "our" flag does not fly. Presumably, if nationalism had not been invented (see Weber 1976 and Tyrrell 1996), it would have had to be: nationalist norms help people navigate the complicated world of politics. Nationalism points toward egalitarian policies within the borders of a given nation-state (cf. Greenfeld 1983), but it conveniently limits our obligations beyond those borders.

The threat nationalism poses to the second LIEO can be gauged not only by recalling what led to the demise of the first one, but by going back even farther, to the foundations of the Pax Brittanica in the nineteenth century. To take only the example of money, Lal argues that Britain's global financial system worked because it was sufficiently insulated from democracy that it could occasionally be inflationary—but without opening the door to demands for inflation at inappropriate times made by politicians who, like their constituents, were not only economically illiterate, but were nationalistic enough to favor beggar-thy-neighbor monetary policies. In other words, had Britain had a more responsive political system, the gold standard would not have worked; and in the early twentieth century, when the world became more democratic and thus more nationalistic, the gold standard collapsed.

One writer in these pages, Kevin Dowd, takes an inevitabilist posi-

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tion, predicting not only that a laissez-faire world financial system would tend to converge on a currency or currencies tied to commodities; but that the same pressure that would lead to that convergence *given* a laissez-faire financial regime—the cost, in inflation and financial insecurity, of floating exchange rates—will (inevitably) lead to such a regime, transforming the current, state-controlled financial system into a free-market paradise. But the latter prediction assumes that those in control of the monetary system understand, and agree with, Dowd's monetary theory. It is one thing to maintain that, under a laissez-faire financial system, people would tend to choose commodity-based currencies because such currencies would be less prone than fiat currencies to lose their value. This prediction assumes merely that people would respond to the superior performance of one currency over another, about which they would receive direct feedback in the form of how much their currency could buy. It does not, however, assume that they would understand the *reasons* for the performance of their currency. It is entirely different to forecast that people will grasp monetary theory sufficiently to understand the appropriate response to the failures of the current regime. If this were a reasonable prediction, one wonders why the first LIEO—which was undergirded by a monetary system quite similar to the one Dowd envisions as inevitable—came to an end. If people grasped the costs entailed by departures from commodity-based currencies, we wouldn't need economists to explain them to us. But people do not, so we should not assume that financial crises will not continue to be blamed on too much laissez faire rather than on not enough of it—or that our LIEO will be any more permanent (or any more laissez faire) than its predecessor.

Economics is a difficult subject, and few people have the time or inclination to specialize in it. Even those who do, such as observer-participant George Soros, can easily be led, by the use loose of such terms as "capitalism" and "laissez faire," to favor—in their normative prescriptions and political agitation—interventionist policies of the sort that they blame—in their empirical analysis—for past financial crises. Dismissing as inherently dogmatic the argument Eichengreen makes below (as does Garett Jones in his more systematic treatment of the issue) that the Asian financial crisis was largely attributable to "moral hazard"—overly risky investor behavior, encouraged by past government bailouts—Soros insists that we live in a laissez-faire dystopia; that "market fundamentalism" rules the world of practice,

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just as (he claims) it rules the world of theory; and thus that the only way to prevent future financial crises is to erect even more powerful political institutions than those we now have.

The new institutions, Soros (1998, 109–111) implies, would not only strengthen democracy while weakening the "capitalism" that now reigns "triumphant" (ibid., 102); they would manage to rule more successfully than the institutions now in place. Yet elsewhere Soros (ibid., 121–22, 169, 180–81) himself describes moral hazard as at least a large part of the reason for systemic failures in the status quo. Rather than striking at the root of moral hazard—an IMF that is responsive to the needs of large investors (ibid., 181)—Soros prescribes a somehow-depoliticized IMF that would be as stringent with those who make bad loans as those who accept them (ibid., 182). But if the problem is the politics that leads to moral hazard, solving it by creating new political institutions amounts to assuming the problem away.

Because Soros construes the status quo as nearly devoid of government intervention, he overlooks the anti-interventionist implications of his own narrative of the system's failure through moral hazard encouraged by just such intervention. If the reasoning of as experienced an analyst as Soros can so easily go astray, it is hard to agree with Dowd that the relevant political actors will inevitably understand the political causes of future financial crises and will gravitate toward his solution.

What really does the work in Dowd's laissez-faire vision is the disappearance, from the financial scene, of democratic politics. Democratic governments will only "compete" with each other in a way that might lead to Dowd's monetary reforms if their monetary officials decide to compete; and they will make that decision only because they believe that in so doing, they will advance the national interest (a belief they clearly do not hold at present), or because they feel pressure from their electorates. But electorally generated pressure would require the voters to know what has gone wrong when financial crisis strikes. Dowd is, therefore, asking even more in the way of theoretical sophistication from the economically unschooled public than he is from monetary officials, most of whom would violently disagree with his views.

Similarly, despite his theoretical (and philanthropic) support for democracy, Soros's new global-finance institutions would work only if they were immune from political pressures of the sort that led to past mistakes (and only if they somehow possessed a measure of wis-

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dom that has escaped even the shrewdest of the world's finance ministers; Soros 1998, 139). Thus, to preserve a measure of global economic openness, Soros would shift the level of government intervention to such a distant remove from popular politics that it would resemble the Bank of England in its heyday. But this means that his real target is not an imagined regime of global laissez faire, but the pressures for local and global bailouts generated by democratic politics (along with the failure of unelected bureaucrats to rule as wisely as he would rule).

The Tainted Idealism of Antiglobalism

The logic of globalization, which so captivates free-marketeers that they imagine its inevitability, is, in fact, counterintuitive. When we think of financial markets most of us see not order but chaos; and when we take notice of the Third World at all, our hearts are torn by the degradation of the sweatshop, not gladdened that it has replaced even worse working conditions—or no work at all.

Compassion that leaps across national borders is the idealistic basis of the new antiglobalist left. But while the new activists have transcended parochial norms, they have not managed to articulate an alternative to globalization that could realistically be expected to enrich as many people as the billions it is now lifting from poverty. They too readily overlook the question of why so many residents of the Third World choose the drudgery of the sweatshop: to ask the question is virtually to answer it. Working conditions that do not meet our standards are deplorable *to us*—at least when a TV broadcast makes them visible to us. But what is not reported by the mass media cannot be seen, and that includes the conditions supplanted by factories we would never visit, let alone work in: conditions so bad that the people subjected to them clamor for the "sweated" alternative (e.g., Kristof 1998, A1).

Any compassionate person wants to promote alternatives that will help people trapped in such conditions; but which alternatives would really help? If not by working in internationally financed factories—sweatshops like those that, during the first LIEO, created the First World by moving millions of people out of poverty in Britain, the Continent, and the United States—how are the world's impoverished to leave poverty behind? One way would be for them to do so liter-

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ally, by moving to places where there is better-paid work for them to do. But that option has been closed off by First-World immigration restrictions. The most important upshot of democratic politics has been nationalist inteference not in the movement of money or goods or capital, but in the movement of people. Having broken with laissez faire by closing the legal gates to most immigrants; and being unwilling to redistribute a significant proportion of their wealth to those in need in the Third World (even if a realistic way could be found to get it to them without undermining economic self-sufficiecy or feeding local kleptocracies); we would seem to be left only with the alternative of unrestricted investment in the Third World and free trade in the goods produced by it.

Why should investment and trade be unrestricted (whether by governments, government-empowered unions, or socially conscious investors)? Because each restriction, by bringing Third-World labor standards above the market-clearing level, reduces some of the competitive advantage that makes job-creating investment in the Third World profitable. Perhaps the best way to think about the difference between the new LIEO and the old one is to notice that, in the more politicized context of the current era, the profit motive, far from being turned loose, has been channeled by democratic states into investments abroad that, being less visible, are less likely to trigger nationalistic resentment than would the mass migrations of foreign workers that, along with the unimpeded flow of investment, characterized the old economic order. Instead of allowing capital and labor to flow to sources of raw material, capital and raw materials must now flow to the source of labor.

Like Soros, Lori Wallach—the closest thing there is to a leader of the antiglobalism movement—considers herself a proponent of greater democracy (Naím 2000, 47); but, pressed on the point, her prescription for a more democratic global economy turns out to involve not the abolition of nation-states and the empowerment of a global electorate, but the exercise of control over existing nation-states, and the international organizations they run, by means of the protest politics in which Wallach specializes. Also like Soros, Wallach acknowledges (if back-handedly) that the "corporate capitalism" to which she objects is grounded in government intervention—transportation subsidies, for instance (ibid., 45)—not in laissez faire. But, again like Soros, rather than opposing at its root the state's power to intervene, she would simply substitute her own list of desirable inter-

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ventions (ibid., 45–46), wishing away the question of why democratic politics has produced the "evil" policies she opposes (ibid., 53). The key thing is to put people like herself in charge of First-World states and the international agencies they control; this is desirable not because it would mean a more genuinely populist form of world economic governance, but because people like her are "looking at the public interest, and trying to balance that against corporate interests," whereas the First-World governments that now pull the strings are "basically fronts for their corporate interests" (ibid., 49). If formal democracy is a sham, then real democracy is, for Wallach, rule by the organizers of media spectacles that can create public opinion.

It seems, then, that under the guise of a democratic anticapitalist, what we find in Wallach is an elitist who, were she to be more realistic about the abilities of Platonic guardians like herself, might even end up favoring laissez faire. The (unregulated) market; or (putatively) wise bureaucratic regulators; or the public (and its demagogues): the choices are few, and none are entirely satisfactory.

Nearly the whole disquieting picture is captured in the work of Adam Smith: how nationalism, when married to economic ignorance, produces policies that impoverish in the name of enrichment; how susceptible the voter and the politician are to special pleading; how the logically impeccable case for free trade is less than politically spellbinding; and, most importantly, how the benefits of capitalism flow to the poorest of the poor. In *The Theory of Moral Sentiments*, written long before *The Wealth of Nations*, Smith painted the last point in the image of "the poor man's son," who dreams that wealth will make him happy (IV. i. 8). In pursuit of his dream, the boy makes himself into an entrepreneur who, at the end of his life, discovers—consistent with the findings of contemporary pychology—that, in fact, money does not buy joy. But this does not mean his efforts were wasted: in his quest for luxury, he has employed thousands whose lives might otherwise have been ended by a single bad harvest. The entrepreneur unwittingly sacrifices his happiness to relieve the suffering of the many, supplying from his useless luxuries their distance from poverty.

We of the First World, whether entrepreneurs or wage laborers, are the poor men's sons of the second era of global capitalism. We drive ourselves harder than any taskmaster to get the money we imagine will bring us fulfilment. But the real value of our lives, in economic terms, lies in the fact that our mutual funds invest in factories that

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employ the impoverished of the world, who would otherwise live on the knife-edge of starvation; and in the fact that we finance not only the production, but the consumption, of the goods those factories produce. Those moved to action by compassion might be better advised, then, to buy foreign-sewn clothing than to protest globalization. Such protests are not futile attempts to stop the inevitable; their danger is that they may well succeed, further retarding, or even ending for the second time, the relief of suffering that only "capitalism" has yet achieved.

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Charles Wolf, Jr.

GLOBALIZATION: MEANING AND MEASUREMENT

ABSTRACT: *While there is much that is new about globalization, there is much about it that is familiar. As in the past, while globalization produces both winners and losers, aggregate gains exceed aggregate losses, and gains and losses occur within both rich and poor countries. While the rich tend to grow richer, so do the poor. Absolute measures of income inequality often increase with globalization, though they are not caused by it.*

Millions of words have been written, hundreds of conferences convened, and dozens of books published about globalization. Yet the subject remains clouded, if not obscured, by the rhetoric surrounding it.

The situation recalls a comment by an eighteenth-century philosopher, sometimes referred to as the "first American." Said Benjamin Franklin (I paraphrase slightly): Where there is "a flood of words," there is usually only "a drop of reason."

Or, to cite an anonymous seventeenth-century poet: "Where words most abound, much sense beneath is rarely found."

As a result of the rhetoric, media hype, and spin associated with globalization, as well as the occasionally violent demonstrations against it, globalization has become a convenient scapegoat for many things—indeed, for almost anything, and sometimes seemingly for everything. Globalization has been blamed for the Asian financial crisis of 1997–98,

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the Russian economic plunge in 1999, global warming, hormone-treated beef, the spread of foot-and-mouth disease in Europe, and even piracy in the South China Sea. The phenomenon recalls the role of the Vietnam war as an all-purpose scapegoat for anything that went wrong in the 1960s and 1970s: American stagflation, the rise of the drug culture, even the sharp increase in teenage pregnancy in the United States.

Use of the term "scapegoat" doesn't mean that globalization has had no contributory responsibility for any of the untoward developments mentioned above. But in each case, the predominant causes and responsibilities lie elsewhere. For example, the Asian financial crisis was caused mainly by misguided policies—especially by mismatches between the maturities of borrowed funds and those of the projects for which they were used—rather than by anything properly attributable to globalization.

What Is "Globalization"?

Globalization has been used in so many different contexts, and with so many different connotations, that it recalls Humpty Dumpty's pronouncement: "When I use a word it means just what I choose it to mean—neither more nor less." It would seem desirable to arrive at a reasonably clear definition of globalization before considering how to measure it.

The dictionary defines globalization as "the act, process, or policy of making something worldwide in scope or application." Before dismissing this definition as too simplistic, it is worth recalling Ernest Rutherford's observation that unless you can state a technical point in simple, non-technical language, you probably don't really understand it.

Other definitions add complexity:

- "[Globalization is] the intensification of worldwide social relations . . . in such a way that local happenings are shaped by events occurring many miles away." (Giddens 1990, 64)
- "Globalization reflects a more comprehensive level of interaction than in the past, . . . something different from the word 'international.' It implies a diminishing importance of national borders and the strengthening of identities . . . beyond those rooted in a particular region or country." (Berresford 1997, 1)
- "Globalization is the growing economic interdependence of coun-

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tries worldwide through the increasing volume of cross-border transactions in goods and services and of international capital flows, and also through the more rapid and widespread diffusion of technology." (Zonis 2001, 2)

- "Globalization is not a policy option, but a fact . . . all states will share access to the majority of the technology underpinning the modern military." (Hicks 2001, 1, 3)

The first three of these quotations are representative of many generic definitions, while the fourth has a more distinctive, and perhaps slightly paradoxical, quality. The paradox is that, while proclaiming globalization as a "fact" and not a "policy option," its focus on the emerging reality of a "global commercial-defense industrial base" actually opens up a wide range of differing policy options: for example, easing or restricting controls on the export of military or dual-use technologies, procuring military equipment abroad or confining procurement to the defense industry at home, and so on.

I suggest the following, somewhat syncretic definition, which will underlie much of what follows in this paper:

- Globalization is the increased speed, frequency, and magnitude of access to national markets by non-national competitors.

In defining globalization this way, I intend it to encompass *all* markets: social, cultural, and recreational markets (including markets for intellectual property, literature, film, media, music, and sports), as well as those for merchandise and commercial services.

How Can It Be Measured?

The preceding definition implies several tendencies in global and national markets as globalization proceeds. These conditions should, in turn, affect the identification and design of appropriate indicators or metrics for globalization.

First, and most obviously, my definition implies that globalized markets have become and are becoming more integrated.

Second, to the degree that there is globalization that meets this definition, increased access to national markets by non-national competitors should lead to a reduction in disparities across countries in prices,

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wages, and real interest rates (after allowing for the costs of hedging against exchange-rate risks).

Third, with the decline in price gaps among countries, price correlations between markets should increase, and divergences of output patterns across markets should rise due to enhanced opportunities for specialization and the effect of comparative advantage.

Fourth, differences between savings rates and investment rates within countries should increase, because the mobility of capital should make investment rates less dependent on savings rates than has been true in the past.

By contrast, typical measures of globalization have focused on the magnitudes of trade transactions and capital flows, based on the premise that the larger these magnitudes, the greater the prevalence or expansion of globalization. But for various reasons, the volume of trade and capital is at best an imperfect indicator of the degree of globalization. For example, trade and capital transactions are subject to wide fluctuations, and the reliability and comparability of the underlying data are often questionable. Trade can be distorted through national policies—such as subsidies that encourage exports, or tariffs and other barriers that restrict imports—that are not caused by globalization. Consequently, such policies may either obscure or exaggerate the extent of globalization.

Thus, one frequently used indicator of globalization is the proportion of gross domestic (or global) product devoted to exports. Table 1 below summarizes the long-term trend in global exports as a fraction of global product.

As the figures in Table 1 indicate, the ratio of exports to global product moves up and down over time. Indeed, during a decade that has

Table 1. Exports as Percentage of GDP, 1870–1999

Years						
1870	1913	1950	1973	1987	1995	1999
5.9	8.2	5.2	10.3	12.8	17.3	15.0

Sources: O'Rourke and Williamson 1999; DOC/BEA 1995, 1999. Data for 1870–1987 cover only merchandise exports for OECD countries; data for 1995–1999 are global and cover *all* exports.

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typically been viewed as a period of relentless globalization, the ratio fell between 1995 and 1999.

The volume of international capital flows is another imperfect, albeit useful and relevant, indicator of globalization. As with trade data, capital flows are subject to distortions of various sorts, such as tax policies and government-subsidized investment guarantees.

Contrary to the conventional wisdom, Kevin H. O'Rourke and Jeffrey G. Williamson (1999) have found that foreign capital flows relative to domestic savings were considerably larger at the start of the twentieth century than at its end. However, whereas long-term capital flows at the turn of the nineteenth century were overwhelmingly in the form of loans, now they consist mainly of foreign direct investment and, to a lesser extent, of portfolio equity investment. One particular form of current capital flows that was virtually non-existent in bygone periods is foreign direct investment associated with transborder mergers and acquisitions. For example, in 1999, such investment amounted to $800 billion, representing an increase of almost 50 percent from the prior year.

As noted earlier, we might expect on theoretical grounds that globalization should be associated with widening differences between domestic savings and investment rates as the integration of global capital markets increases. Figure 1 shows the varying correlations between domestic savings and investment rates from 1872 to 1987. While a lower coefficient (the vertical axis of Figure 1) implies a higher degree of integration in global capital markets, the figure shows—once again contrary to much conventional wisdom—that capital markets appear to have been more closely integrated before World War I than currently!

In an effort to develop new and improved measures of economic "openness"—an important aspect of globalization, albeit not the whole story—a recent RAND study (Wolf, Hugh, and Tong 1999) devised three additional measures of the relative degree of market access (i.e., economic openness) in five countries: the United States, Germany (as a proxy for the European Union), China, Japan, and South Korea. These measures were based on (1) a survey, distributed to the top executives responsible for international operations in 500 multinational corporations, on the relative ease of engaging in trade or investment business in the five countries; (2) a detailed review of legal and administrative documents in each of the countries, assessing the extent to which foreign business operations were restricted or prohibited; and (3) comparisons between the purchasing power (the so-called real value) of each country's currency and its foreign-exchange ("nominal") value. (Other

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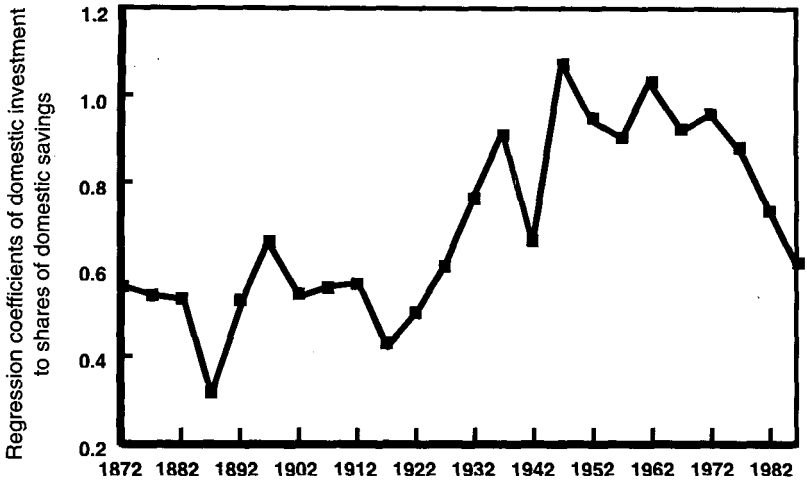
Figure 1. Integration of Global Capital Markets: One Indicator



Sources: O'Rourke and Williamson 1999; Taylor 1996. Data are for Atlantic economies.

things equal, the more "open" an economy, the closer the "real" and "nominal" values of its currency should be.)

The survey was conducted over a five–month period in late 1997 and early 1998, with a response rate of 60 percent. Respondents were asked to answer a 10-page questionnaire rating the degree of restrictiveness in each of the five countries on a six-point scale (from 0 to 5). Table 2 shows the aggregate response means from the survey; Table 3 shows the openness index resulting from the review of legal and administrative documents and regulations; and Table 4 shows the results of the comparisons of currency exchange values.

The results shown in Table 4 diverge slightly from the close congruence between the rankings of openness displayed in Tables 2 and 3. Yet even this slight divergence (i.e., the shift in ranks between Germany and Korea) is readily attributable to two factors: the differing time period covered in Table 4 compared to those in Tables 2 and 3; and the sharp impact of German reunification costs in the early and middle 1990s on the disparity between the purchasing power and the exchange rate of the deutschemark. In any case, it is evident that the overall economic openness rankings shown in the three tables for the five countries is strikingly similar.[1]

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Table 2. Executives' Assessment of Openness to Trade and Investment, 1997–98

Country	Openness in Trade	Openness in Investment	Aggregate Openness[a]
United States	1.71	0.97	1.35
European Union	2.43	1.67	2.07
Japan	3.34	2.86	3.13
South Korea	3.21	3.42	3.30
China	3.41	3.94	3.64

[a]Based on aggregate answers to twenty questions in the openness questionnaire: low index values signify less restriction, hence greater economic openness. The aggregate openness index is an unweighted average of the trade and investment indexes, subject to rounding.

Table 3. Aggregate Openness Index Based on Surveyors' Evaluations of Administrative and Legal Regulations, 1997–98

Country	Trade	Investment	Overall
United States	1.63	0.90	1.27
European Union	2.53	0.77	1.65
Japan	3.40	2.77	3.08
South Korea	3.77	3.00	3.38
China	3.83	3.77	3.80

Table 4—Normalized Differences Between Purchasing Power Parities (PPP) and Exchange Rates (XR), 1991–1995

	Average PPP	Average XR	PPP-XR XR	Openness Ranking
United States	1	1	0	1
Germany (DM/$)	2.14	1.58	0.35	3
Korea (won/$)	526	778	0.32	2
Japan (yen/$)	184	114	0.61	4
China (RMB/$)	1.43	7.0	0.81	5

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Although the metrics we have used may be helpful in calibrating globalization, they clearly fall short of providing an adequate measure of the phenomenon. However, if we can assume that economic openness corresponds more or less closely to the diffusion of globalization, it can be said that globalization has penetrated the United States and the European Union more fully, with Japan, Korea, and China well below them, but grouped fairly closely to one another, for the time periods covered by the measurements.

How Much Globalization Is There, and How Much of It Is New?

There is no question that some aspects of globalization are genuinely new. These include developments in information technology, the doubling of computer chip capacity every 18 months (Moore's Law), the connectivity of the Internet, e-mail, e-commerce, transborder mergers and acquisitions, and the scale of foreign direct investment. Nevertheless, there is a tendency to exaggerate the novelty as well as the magnitude of globalization as a result of situational myopia, media hype, organized protest demonstrations, and simple forgetfulness of history. Contrary to the conventional wisdom, the data presented here show that international trade as a share of GDP has reached higher levels in the past than recently; that correlations between domestic savings and investment rates were lower at intervals in the past than currently; and that foreign access to domestic markets still varies widely among countries, despite the alleged inevitability of a "race to the [free-trade] bottom."

In a notable recent study (O'Rourke and Williamson 1999, 216) that tries to place current global trends in historical perspective, the authors characterize the global economy in 1914, immediately prior to the First World War, as one in which there was

> hardly a village or town anywhere on the globe whose prices were not influenced by distant markets, whose infrastructure was not financed by foreign capital, whose engineering, manufacturing, and even business skills were not imported, whose labor markets were not influenced by the absence of those who had emigrated or the presence of strangers who had immigrated.

That the same can, in some cases, be said about the world of the early twenty-first century should alert us that, in "globalization," we are ex-

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periencing something that, for all its distinctive features, has many precedents.

One reason this old-fashioned process continues—in fits and starts—is that it is not a zero-sum game. Although there are losses and losers, as well as gains and winners, the gains exceed the losses. While low-wage labor in developing countries is "exploited" by the increased penetration of foreign business and investment there, this creates benefits and opportunities that the low-wage laborers would be denied without globalization.

It is also worth noting that the gains and losses, and their corresponding beneficiaries and victims, occur within both the rich and the poor countries. When foreign businesses gain access to a given domestic market, they may disrupt high-cost, less-efficient competitors—whether the market in question is that of a developed or a developing country. Indeed, most of the anti-globalization protest demonstrations that have occurred in recent years have been led by individuals and organizations from rich, developed countries, rather than poor developing ones. It is true that globalization has been accompanied by increased income inequality (although the former doesn't necessarily cause the latter). Typically, average rates of income growth have, in the aggregate, been similar for the rich, the poor, and those in between, resulting in widened income disparities in both developed and developing countries. But this is to say little more than that while the rich have been getting richer, so has everyone else.

NOTE

1. The probability is less than 2 percent that the rankings of economic openness shown in Tables 2, 3, and 4 for the five countries are random. See Wolf, Levaux, and Tong 1999.

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Douglas A. Irwin

THE TWO FACES OF GLOBALIZATION

ABSTRACT: *Fears about economic globalization overlook the fact that the growing international division of labor can be beneficial to all participants—as may be seen in the spectacular strides that have been made recently by once-impoverished developing countries. Free trade does threaten some, but the negative effects of international trade even on developed countries such as the United States have been vastly overstated. Western workers are rich because of their high productivity, not (primarily) because of their insulation from competition. Ignorance of these facts, however, fuels support not only for specific trade barriers, but for Seattle-style activism that threatens to harm the very people it is intended to benefit.*

If "competitiveness" was the international economics buzzword of the 1980s, "globalization" clearly replaced it in the 1990s. Though "globalization" has become a stock phrase—any term that signifies a very broad phenomenon faces the danger of losing precise definition and becoming vague and ineffable—serious international and domestic economic issues lie behind it. If "globalization" is nothing more than shorthand for the increasing economic integration of nations, it is abundantly clear why the fin-de-siècle public latched onto it. Public awareness, if not understanding, of the global economy has been high in recent years, starting perhaps with the hotly debated North American Free Trade Agreement (NAFTA) and continuing with the protests surrounding the Seattle meeting of the World Trade Organization. And concern about globalization encompasses a multitude of other issues,

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ranging from the outsourcing of employment by American multinationals, to congressional funding for the International Monetary Fund, to worries about the global fallout of the Asian economic crisis.

Both *Globaphobia: Confronting Fears about Open Trade* (Washington, D.C.: Brookings Institution, 1998), by Gary Burtless, Robert Z. Lawrence, Robert E. Litan, and Robert J. Shapiro, and *Has Globalization Gone Too Far?* (Washington, D.C.: Institute for International Economics, 1997), by Dani Rodrik, provide excellent introductions to the broad economic issues—mainly regarding international trade rather than international finance—that fall under the rubric of "globalization." Although they deal with similar issues, however, the books differ markedly in tone and emphasis.

Globaphobia is a spirited rejection of the idea that globalization is responsible for any of the economic ills afflicting the United States. Burtless et al. first set out the simple facts about U.S. trade with the rest of the world and a context in which to view those facts. They then seek to dispel popular fears about U.S. participation in the global economy and to strongly defend the American commitment to an open world trading system.

Rodrik's book has some common ground with *Globaphobia*, but it is also a penetrating, controversial critique of the way in which economists (such as Burtless and his colleagues) have traditionally analyzed globalization. As its title suggests, *Has Globalization Gone Too Far?* is much less sanguine about globalization and raises potentially more disturbing issues than *Globaphobia*. Rodrik's views, however, cannot be understood if one is unfamilar with arguments of the sort that are presented in *Globaphobia*.

Old Myths About Globalization

The explicit purpose of *Globaphobia* is "to demonstrate that the fear of globalization . . . rests on very weak foundations." To persuade the reader of this conclusion, the authors—an impressive team of economists from several Washington think tanks (dominated by the Brookings Institution)—explain why international trade is a positive-sum activity from which all participants benefit. Trade between regions within a country allows those regions to be better off because they are able to specialize in the production of certain goods and need not produce everything for themselves. So it is with trade between countries, even if

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labor cannot move between countries as easily as it can between regions within a country. The division of labor enables output to be larger than it would be in the absence of specialization; countries share this larger output through international trade. This reasoning is standard economics, but it is oft forgotten and cannot be repeated too frequently for noneconomists.

After setting forth the classic case for free trade, *Globaphobia* attacks many popular American perceptions about the costs of globalization. First and foremost is the claim that trade destroys jobs—which is true, but only in a very limited sense. Employment in the Maine shoe industry and in the South Carolina textile industry is lower to the extent that consumers forego their products in favor of imported goods. But, as *Globaphobia's* authors show, trade-induced job loss is an extremely small proportion of overall labor turnover. For example, they ask, did NAFTA reduce U.S. employment by liberalizing trade with Mexico? Their answer:

> By any reasonable measure, even the gross job turnover induced by the agreement has been slight. According to the Department of Labor, over the nearly four years from January 1994 through mid-August 1997, 220,000 workers had petitioned for adjustment assistance (cash and training allowances) under the legislation enacted when the trade deal was signed. Of this total, 136,000—an average of about 40,000 workers per year—were certified as eligible for assistance (under both the more general trade adjustment assistance program and that created as part of NAFTA). Even this figure overstates NAFTA's true impact, because to be eligible under both programs workers only need to show that "imports" have contributed to their losses, but not specifically as a result of NAFTA. By way of comparison, the gross monthly turnover of jobs in the United States exceeds 2 million. Since NAFTA, overall employment in the United States has risen by more than 10 million. (57)

So much for the "great sucking sound" that Ross Perot and others had predicted.

Even if NAFTA had produced more job loss than it did, however, more trade cannot result in lower employment. Imports—for example, imports into the United States—are not free. They must be paid for in one of two ways: through exports of U.S. goods and services, or through foreign investment in the United States. All of the dollars U.S. consumers hand over to other countries to buy their imports will return either to purchase U.S. goods exported abroad or U.S. assets cre-

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ated by foreign investment. Both exports and investment create new jobs.

How can we be sure that the number of jobs destroyed by imports are at least matched by the number of jobs created by exports and foreign investment? If the unemployment rate began to rise, then the Federal Reserve Board would probably reduce interest rates in an effort to head off a recession. This would not only stimulate the economy, but would also tend to depreciate the dollar, thereby encouraging more exports and discouraging imports. The simplistic claim that globalization destroys jobs is erroneous. It is conceivable, however, that globalization could be bad for other reasons, such as the "quality" of the jobs that remain.

Thus, it is feared that, for instance, trade is "deindustrializing" the United States. Imports and foreign investment outflows by U.S. companies, it is said, have destroyed good manufacturing jobs and have hollowed out America's economy. This mantra of the early 1980s is less fashionable these days, but the fear of multinational outsourcing still lingers close to the surface of trade-policy debates. *Globaphobia*'s colorful charts, however, show that the shift from manufacturing toward services is a trend common to all developed countries. In fact, this shift has proceeded even more in other developing countries, which is to some degree reassuring because ruin has not befallen them. The authors demonstrate that higher productivity growth in manufacturing compared to service industries—not the trade deficit or unfair trade practices—is the root cause of deindustrialization. Simply put, developed countries have been able to produce more manufactured goods with fewer people. In service industries, this productivity performance has been difficult to achieve.

The authors then turn to the link between trade and wages, a controversial topic that, in recent years, has been the subject of considerable economic research. One of their charts illustrates that the course of average U.S. wages over time has virtually nothing to do with international trade flows (60). The same chart shows that worker compensation tracks nonfarm business productivity in an extraordinarily direct way. Real wage growth is inextricably and inexorably tied to productivity growth. As productivity growth slowed after the early 1970s, so did real wage growth. (This raises the question of whether trade had any detrimental effects on productivity, but some evidence suggests that international competition has actually spurred productivity improvements in import-competing sectors.)

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If trade has little impact on average wages, has it affected the distribution of income, exacerbating the gap between rich and poor? There has been no significant change in labor's share of total national income for many decades. But economic theory provides clear support for the notion that trade can increase the rewards of skilled workers while reducing those of unskilled workers (or the other way around, depending on the conditions) in a country facing international competition, as imports tend to displace unskilled workers and exports tend to embody skilled labor.

There is no debate that U.S. wage inequality has risen since the 1980s: the wages paid to skilled workers have risen while those of unskilled workers have stagnated or fallen. To what degree has trade contributed to this development? Grappling with this question has proven difficult and complicated. Most empirical research indicates that trade has had a small effect on wage inequality. Burtless et al. add that the decline in pay and in the use of workers with little education has proceeded apace in both trade-sensitive industries and in industries insulated from trade. They therefore contend that trade cannot be a major part of the "problem." The authors instead proffer the widely held notion (among economists, at any rate) that technological change has raised the demand for skilled workers and is therefore the principal cause of growing wage inequality.

New Fears about Globalization

Dani Rodrik's *Has Globalization Gone Too Far?* is far more critical of globalization. The fundamental question Rodrik poses is whether social disintegration is the price of economic integration. Globalization, he writes, "is exposing a deep fault line between groups who have the skills and mobility to flourish in global markets and those who either don't have these advantages or perceive the expansion of unregulated markets as inimical to social stability and deeply held norms" (2). He concludes that "globalization delivers a double blow to social cohesion—first by exacerbating conflict over fundamental beliefs regarding social organization and second by weakening the forces that would normally militate for the resolution of these conflicts through national debate and deliberation" (29). Rodrik fears that those who can adjust to economic change—capital owners, skilled labor, and professionals—will be increasingly pitted against those who cannot—unskilled and semi-

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skilled workers. This conflict, he contends, could undermine the post-war "social bargain" in which steady pay increases were exchanged for labor peace.

Such a social bargain, though often referred to, strikes me as the imaginary construct of academic social scientists. In the United States, at least, "capital," "labor," and "the state" are abstractions that never actually sit down at real tables to strike corporatist deals. As *Globaphobia* illustrates, rising living standards have everything to do with advancing productivity, not with bargains brokered by the state or pressure exerted by labor unions.

Still, the potential for conflict is real and Rodrik is creative in searching, where others have failed to look, for sources of that conflict. In doing so, he is sometimes critical of his fellow economists. For example, while many economists, such as Burtless et al., have been investigating the role of trade in the widening wage premium for skilled workers, Rodrik argues that trade may instead be responsible for increased labor market instability and insecurity, most of which is borne by unskilled workers. Because these issues have been left unexamined, there is precious little evidence to which we can turn in order to evaluate their actual importance.

Rodrik's own analysis is a start, but not a completely persuasive one. For example, he makes the somewhat plausible claim (for which, however, we have no evidence) that "in an integrated world economy, higher labor standards cost workers more in terms of both wages and jobs" (17). The reason, he posits, is that globalization (specifically the ability of firms to locate abroad) has made the demand for domestic labor more elastic, since more international substitution possibilities are available. He then uses a simple supply-and-demand framework to illustrate that, as the demand for labor becomes more elastic, more of the cost of labor standards is borne by workers rather than firms.

Aside from the assumption that labor demand has in fact become more elastic, Rodrik's argument hinges on workers reducing the labor they supply if wages fall. Yet labor economists typically view labor supply as not being very responsive to wages. If this is the case, the elasticity of the demand for labor is irrelevant: workers have and always will bear the lower wages that are the price of higher labor standards in terms of lower wages, and globalization has changed nothing.

Rodrik also worries that globalization will adversely affect the bargaining power of organized labor. He notes that de-unionization could potentially be a good thing, freeing the economy of such inefficiencies

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as wages high enough to price less-skilled workers out of the market, but he cautions that "efficiency benefits are reaped only to the extent that employment *expands* in industries in which artificially high wages previously kept employment below efficient levels" and that "it is difficult to make a prima facie case that expanding trade has in fact led to more hiring in sectors such as steel and autos in the United States" (25). Yet such a case may not be that difficult to make. According to the 1996 *Statistical Abstract of the United States*, the number of production workers in the motor vehicle industry expanded from 575,000 in 1980 to 617,000 in 1990 and 759,000 in 1995.

Rodrik next contends that globalization raises the "social cost of maintaining divergent social arrangements" (29). This proposition is, again, plausible, but Rodrik does not really demonstrate it. After making several uncontroversial claims, such as that trade can have distributional effects that conflict with common notions of fair play; that there is a perceived difference between comparative advantage shaped by relative factor endowments and that shaped by different institutional arrangements; and that trade can impinge on long-standing implicit social contracts, Rodrik concludes that we cannot "treat trade liberalization as an end in itself, without regard to how it affects broadly shared values at home." But democratic governments seem to be rather well insulated from any pressure exerted by global competition to undermine such values. In Japan, the government has refused to sacrifice the important social position of Japanese rice farmers on the altar of the global economy. Agriculture in Japan, and to a lesser extent in Europe and America, has been exempt from postwar trade liberalization (which has occurred only recently, and then only in a limited way). Moreover, where such values are sacrificed, it is not for the sake of trade liberalization as an end in itself; it is for the economic benefits that liberalization brings.

Rodrik then turns to globalization and the demand for social insurance. He presents data that show a positive and striking relationship between government spending and openness to international trade. Rodrik concludes that this correlation is not a coincidence. "Societies that expose themselves to greater amounts of external risk demand (and receive) a larger government role as shelter from the vicissitudes of global markets. . . . The social welfare state is the flip side of the open economy!" (53).

But is it true that more "open" economies are subject to greater amounts of external risk? Rodrik is careful to point out that economies

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that are relatively closed to foreign trade are also subject to economic shocks, and that openness to trade can be thought of as a way of spreading risk (due to crop failures and other local calamities). Moreover, there is a tendency for countries that have liberalized their trade policies to see their portfolio of exports become much more diversified. Chile, for example, moved away from being a raw commodities exporter to producing a variety of processed goods. The reason for such diversification could be that lifting import restrictions has the effect of eliminating an indirect tax on exports, enabling a country to export not just a larger volume of the goods in which it had specialized before, but also to export other goods. This diversification reduces economic risk. Rodrik's point is that openness to trade forces a country to specialize in certain goods, which suggests more exposure to risk. Yet that openness might also generate higher incomes and promote a variety of specialized domestic industries, which may counteract this risk.

* * *

The multiplying protests against globalization suggest that doubts of the sort expressed in sophisticated form by Rodrik can mobilize many thousands who are entirely innocent of economics. One drawback of *Globaphobia* is that, like many of the protestors, it is rather narrowly focused on fears that increased international integration could have negative effects on domestic employment or wages in the developed world, underplaying the huge benefits of globalization for the desperately poor of the Third World. But such are the political realities. The continued willingness of developed countries to keep their markets open to imports from developing countries will probably hinge on whether domestic misconceptions, such as those so effectively dispelled by Burtless and his colleagues, gain new adherents in coming years.

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Jason Sorens

THE FAILURE TO CONVERGE: WHY GLOBALIZATION DOESN'T CAUSE DEREGULATION

ABSTRACT: *Conventional wisdom holds that the rigors of fiscal competition unleashed by globalization are forcing governments to roll back welfare programs, reduce or eliminate taxes on capital, and reduce regulation on mobile assets. In* Freer Markets, More Rules, *Steven Vogel attacks the latter contention, arguing that regulatory reform has been more often reregulatory than deregulatory, though it is generally undertaken with an eye to increasing market competition. He also maintains that governments have acted autonomously of social interests and market pressures in formulating regulatory reform. While Vogel is mistaken to contend that there has been no net reduction of government control worldwide, his revision of the conventional wisdom requires a fresh look at how susceptible states really are to the global competition for revenue.*

Steven K. Vogel's *Freer Markets, More Rules: Regulatory Reform in Advanced Industrial Countries* (Ithaca: Cornell University Press, 1996) challenges an important part of the received view about globalization: that it has forced governments to slash spending, balance budgets, and deregulate and privatize on a large scale.[1] He argues that states are not hostages of either market or interest-group pressures for economic liberalization in the name of international competitiveness. While global markets and domestic interest groups may provide the impetus for reform, he shows,

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created a private organization, the Securities and Investment Board, which was empowered to govern City financial practices. In 1987, the SIB promulgated an "enormous rule book," provoking a revolt among City practitioners (111–12). In creating the new regulatory board, the Department of Trade and Industry seems to have been more concerned with preventing scandals (several had erupted in the early 1980s) than with cutting costs (116).[5]

In financial services, deregulation and reregulation shared a common cause: the growing complexity and internationalization of financial services. In other industries, the British government privatized and allowed competition while sometimes tightening safety regulations or creating new agencies to regulate privatized monopolies. Vogel calls the aggressive promotion of competition without managing market entry and exit "the British pattern" (an exception would be telecommunications) (129).

By contrast, in Japan close government control survived financial deregulation. The Ministry of Finance (MoF) heavily regulates entry and exit in banking, securities, and insurance, with the aim of preventing bank failures and stock-market volatility (167–70). The impetus for regulatory reform was similar to that in the United States: the traditional distinction between banking and securities was breaking down. The MoF responded by incrementally liberalizing deposit interest rates and partly deregulating the financial system. At the same time, the MoF upgraded its supervisory capacities, tightened disclosure regulations, and promoted mergers between banks (174–75). The MoF was able to take advantage of divisions within the financial industry to enact a "separate subsidiaries" approach to the regulation and integration of banking and securities firms (182–85). And the ministry has retained the right to permit new financial instruments on a case-by-case basis rather than issuing a general permission for certain classes of instruments (192).

Vogel's book demonstrates that certain sectors of the British economy are somewhat less regulated than previously. I would add that American industries such as air travel, telecommunications, electricity, and natural gas have also been deregulated more than they have been reregulated, although electricity and natural gas providers are forced to serve all comers through open-access regulations, and cable television, never freed from local regulations that conferred monopolies on certain carriers, was federally reregulated in the early 1990s. Overall, however, Vogel shows that governments have truly deregu-

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the shape this reform takes depends a good deal on the particular nation's institutional legacy. Sometimes market demands are themselves the result of past policies that governments undertook with full knowledge of the results (12), and sometimes governments defy markets and powerful interest groups when they have other interests at stake (4–5).

Vogel makes a solid case for his central thesis, that governments worldwide have not converged on one neoliberal low-regulation regime. While case-study analysis of the sort Vogel provides cannot conclusively prove this as a universal rule, he persuasively shows that governments often act autonomously of social groups, especially when these groups are ill informed or ambivalent; and that we cannot expect governments to give up discretionary regulatory powers readily, even in an era of globalization and the alleged intellectual ascendancy of free-market economics.

What Is "Deregulation"?

To begin his analysis, Vogel presents a typology of regulatory reform along two dimensions (17). On one axis are reforms that either undermine discretionary bureaucratic control over industry or enhance it; on the other axis are reforms that emphasize either "liberalization" or "reregulation." Reforms that reduce discretionary control while mandating competition he calls "pro-competitive reregulation," which include measures designed to handicap market incumbents or strengthen antitrust enforcement. One might take issue with this description, since strong antitrust enforcement does not necessarily promote competition (for example, when it discourages a large firm's entry into a new product line dominated by another large firm), and it certainly does not usually undermine bureaucratic discretion.[2] Reform with a reregulatory emphasis that undermines bureaucratic control Vogel calls "juridical reregulation," by which he means reform that limits administrative discretion by codifying informal procedures or formalizing regulation into a judicial process. Administrative procedures limit government officials' discretion by forcing them to follow evidentiary rules, limiting the swiftness with which officials may act, or providing a formal mechanism for the regulated firm to provide feedback to the regulatory agency (see McCubbins, Noll, and Weingast 1987).

By labeling this sort of reform "reregulation" rather than "deregulation," Vogel makes it easier to prove his case against the prevalence of

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globalization-driven deregulation, since such changes go on all the time. Most observers, however, would consider it an instance of deregulation—or at least would not label it as additional regulation—when bureaucratic discretion is replaced by formalized procedure. As Vogel's own typology recognizes, this sort of reform involves a net loss of government autonomy. Therefore this type of reform, to the extent it occurs, does not prove Vogel's thesis that there has been, worldwide, "little net loss of government control" (2). Vogel's case is better supported when he provides evidence of regulatory reform that actually enhances the authority of state bureaucracies.

Another problem with Vogel's analysis is that it appears to define any net increase in the number of rules that government promulgates as a move toward more regulation. But if we define regulation this way, then Vogel's object would have been easily achieved with a quantitative study: count up the number of pages of regulation published by the governments of a broad cross-section of countries and see whether the number has fallen; or whether more integration into the global economy correlates with fewer regulations. This approach would have been crude and unreliable not only because the codification of regulations that were previously implicit and vague may actually lessen government autonomy, but also for another reason: when a government privatizes a firm and then imposes regulations on it, the quantitative approach would indicate a net increase in government control, when perhaps the opposite has happened.[3] Falling into this trap, Vogel codes British regulation of telecommunications as an example of reregulation, even though it was preceded by privatization (60).

The other two categories in Vogel's typology are control-enhancing liberalization ("strategic reregulation," such as giving regulatory advantages to domestic firms) and control-enhancing reregulation ("expansionary reregulation," extending regulation to new areas). It is unclear how what the author terms "strategic reregulation" is an instance of liberalization at all; arguably expansionary reregulation is the only sort of reform Vogel has typed correctly. But the details of the typology are not crucial to his thesis. If governments have actually been engaging in expansionary, strategic, and procompetitive reregulation much more than in juridical "reregulation" or other forms of deregulation, then one would be forced to conclude that the deregulatory revolution never happened, and Vogel stands vindicated; if Vogel's case turns out to rely chiefly on instances of juridical "reregulation" it will be much weaker.

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The Myth of Worldwide Deregulation

The thesis that deregulation has not been a secular tendency must immediately deal with the conventional wisdom to the contrary. Vogel argues that there was indeed widespread regulatory change over the last 20 years, precipitated by a crisis that produced a gap between states' goals and their regulatory capabilities (23–24). Technological developments made regulatory regimes outmoded in several ways: by creating new markets outside the scope of existing regulations, by blurring distinctions between lines of business, and by internationalizing markets (26). But, he contends, the resulting need for new regulation did not usually produce deregulation.

Vogel chooses to focus on two industries, finance and telecommunications, and two countries, the United Kingdom and Japan. One problem with this choice is that these countries have been privatizing their telecommunications systems, a step that in some instances, as I have already suggested, represents a retreat from government control even though it is accompanied by new regulations. Nor is finance the most appropriate sector from which to draw conclusions about regulatory reform worldwide, since in this industry what often looks like government regulation is either self-regulation undertaken by securities and commodities exchanges eager to preserve their reputations as honest markets,[4] or else is government regulation that is necessary only because of some other intervention. For instance, the regulation of the investment decisions of banks and savings and loans is necessary only because without it, government deposit insurance would create an intolerable "moral hazard": the temptation of insured institutions to invest wildly, secure in the knowledge that bad loans would be bailed out by government insurance. Vogel does note repeatedly that in finance, government regulation is often necessary because of previous intervention, but he fails to note that finance is almost unique in this regard.

Despite these flaws, *Freer Markets, More Rules* is valuable in pointing out—as its title suggests—how often new regulation takes place under the guise of deregulation. Worldwide, telecommunications privatization and the introduction of competition have been accompanied by regulation of the dominant service provider and, usually, by compulsory divestiture of certain parts of the company, as occurred in the United States. Most often service providers are forbidden from subsidizing their long-distance rates by raising rates on

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local service, which everywhere remains a regulated monopoly (31). In Japan, the Ministry of Post and Telecommunications (MPT) actively limits entry into the telecommunications industry, while maintaining price and service regulation (161–66). In Britain, British Telecom was required to interconnect with a new telecommunications company, Mercury, in the interest of effective competition (76–77). Mercury also successfully lobbied for a seven-year ban on further competition on the grounds that it would undermine its competitive stance with regard to BT (70). The Office of Telecommunications still regulated BT's practices more than a decade after privatization, and the director general of the office, Bryan Carsberg, declared that deregulation probably would not be possible within his lifetime (65–66, 89).

In finance, Vogel shows that new regulation was often stimulated by innovations designed to thwart old regulations. In the United States, a unique regulatory barrier between banking and brokerage (and investment banking as well) prompted the development of new financial instruments to get around the distinction. As a result, the government reformed its financial regulations. On the other hand, regulation has often been designed to allow new financial instruments to develop, preventing capital flight to less-regulated markets. The oft-cited fiscal competition among governments induced by globalization has been at work in finance, since funds can move easily across borders. Deregulation of broker commissions occurred in New York first because investors were able to circumvent them, and once New York liberalized, other financial centers had to follow suit (32).

In the United Kingdom, however, financial reregulation followed on the heels of deregulation. Traditionally, the Bank of England had informally regulated the City (Britain's financial sector) with an eye to its interests, but the regulatory regime placed British traders at a competitive disadvantage. British traders faced fixed commissions and a "single-capacity" system, whereby a firm could be either a "jobber" (a wholesaler) or a "broker" (an intermediary between investors and jobbers) but not both (97, 100). The October 27, 1986 "Big Bang" abolished fixed commissions and single-capacity requirements (107). But these reforms opened the door to foreign financial institutions, whose new presence in London made informal regulation less practicable. This prompted the imposition of a judicialized antifraud regulatory regime, accomplished through the Financial Services Act. It

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lated surprisingly little. Governments have responded to technological change that made existing regulatory regimes less efficient in various ways: sometimes by eliminating the restrictions on private profit-seeking behavior, but more often by merely restructuring them. Most government power over the economy has remained intact or expanded.

Has Globalization Caused Regulatory Reform?

Nonetheless, regulatory reform of whatever content or direction has been substantial of late, and at least some deregulation has occurred in most countries. At the same time, the internationalization of trade and capital has increased. Has globalization caused regulatory reform, if not deregulation, by exerting competitive pressure to allow (or mandate) more competitive markets?

One might expect that such pressure would come from domestic firms disadvantaged by relatively tight regulation. But Vogel shows that government ministries have been able to determine the character of reform according to their historical interests and orientations, without (and even in the face of) pressure from distributive coalitions in society. Vogel supports his case with a staggering array of interview evidence; rather than theorize a priori about the deregulators' motives, he obtained his information directly from the important players. In Britain, for example, the nationalized telecommunications provider, British Telecom, was particularly inefficient (relative to countries like Japan and France),[6] and provided an obvious target for the neoliberal Tory government that took office in 1979, which proceeded with privatization and plans for regulatory liberalization although no group had ever lobbied for it (74). Privatization was not even initially on the Tory agenda; although it clearly accorded with Margaret Thatcher's ideas for reform, it was the brainchild of Secretary of State Sir Keith Joseph, an ardent liberalizer (74–75). Radical regulatory reform was pushed through by a committed set of policy makers, without pressure from social interests.

Perhaps cultural factors, then—the traditions of different countries and the ideas of those in power—have been responsible for regulatory reform. Maybe—and in some cases, certainly—public officials, under the normative sway of market economics, have implemented deregulatory policies they thought would improve social welfare.

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They might have been able to do so in spite of the indifference, and sometimes the opposition, of special interests because of widespread public ignorance of what they were doing.[7] A special interest that cannot mobilize public pressure to get its way (usually in the name of the public interest) will be powerless in the face of a determined government.

However, if state officials are so autonomous that they can translate their ideal policy preferences into law, we should see ideal types of various policy regimes all around us. We should have pure laissez-faire regimes, completely controlled fundamentalist religious regimes, and pure communist states. In reality, though, even Hong Kong and nineteenth-century Britain and America were very far from pure laissez faire, even Iran is far from a completely controlled Islamic society, and the Soviet Union in retrospect looks like a fairly typical bureaucratic-authoritarian regime. If states were completely autonomous, we would expect them to vary much more than they do.

A Theory of State Interests

The relative homogeneity of modern states may be explained by drawing on Theda Skocpol's concept of the state as being "fundamentally Janus-faced," in that it has to deal with international pressures while maintaining effective control over, and legitimacy with, the domestic population (1979, 32). While public ignorance may afford states a large degree of autonomy on the domestic front, international pressures act as a selection mechanism to weed out "weak" states.[8] One such pressure is war. Weak states will succumb to stronger states in battle. Over time, we would expect to see states that are resilient in the face of external military threats. Indeed, even a state's need for democratic legitimacy—and thus the effectiveness of an ignorant *demos* in creating state autonomy—can be attributed to selection pressures. States that were viewed as illegitimate by significant sectors of the public and lacked the resources to suppress these sectors would be subject to coups d'état, revolutions, and partitions. Thus, they would tend to disappear.[9]

In general, if states are to survive, they must be able to extract enough resources from the domestic population to equip a military force sufficiently powerful to resist external aggression, while maintaining a domestic mix of legitimization and repression that prevents revolutions and coups from within. Thus, a domestic bureaucracy is neces-

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sary not only to extract resources for military use, but to provide goods and services that are perceived as desirable by domestic interests. Military and bureaucratic establishments, in turn, need discretionary authority so as to meet domestically perceived needs, mobilize production for war, crush threatening dissent, maintain patronage networks (even strong states must do this to some extent), and, in general, to react to threatening situations with speed and effectiveness.

The two broad requirements of a militarily sustainable state—fiscal stability and domestic control—are usually in tension. To achieve fiscal stability, the state needs a healthy private sector from which to extract funds (the partial structural dependence of the state on capital);[10] overuse of discretionary powers will discourage investment through high tax rates and oppressive levels of regulation, and it will generate domestic discontent over economic interventions and curtailments of civil liberties, particularly if they are applied inconsistently or arbitrarily. Fiscal ill health may also require paring back those state institutions involved in domestic resource extraction, political legitimation, and civil repression.

The relationship between fiscal health and discretionary power can be seen as a sort of generalized Laffer curve. The Laffer curve posits an upside-down U-shaped relationship between tax rates and revenues. Low tax rates mean low tax revenue; high tax rates mean low growth and therefore, again low tax revenue. The revenue-maximizing tax rate lies somewhere in between. We can imagine a similarly shaped relationship between discretionary power and fiscal health. States that are able to limit their discretionary powers, particularly through a credible commitment to maintain this limitation, would in turn be able to maximize not only tax revenues but access to loanable funds through bond markets.[11]

We might say that successful states are highly "institutionalized," in that they have developed institutions that limit their own ability to pursue unsustainable fiscal policies while allowing them to act quickly when their survival is at stake.[12] Therefore, we would expect to see budget-conscious treasury departments checking the discretion of social-service and regulatory departments, and even different regulatory departments checking each other, while supreme military control is concentrated and relatively more autonomous. Another way a state would limit both its discretionary powers and its fiscal instability would be by insulating itself from radical change that might otherwise be im-

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posed by an ideologue (such as Keith Joseph). Bureaucratization (in the sense of "red tape") and departmentalization would achieve this end.

States' Interest in Regulatory Reform

While this theory can, with a little ingenuity, be tested statistically,[13] it also engenders predictions that fit well with the narrative evidence Vogel has marshalled. The theory is able to explain why states respond to external economic shocks, such as globalization and technological change, with reforms that point in a common direction. Vogel and many other researchers have argued that globalization and technological change have made old regulatory regimes more inefficient. In order to promote economic growth and, by extension, revenue growth, states have recently needed to restructure their regulatory regimes, largely in the direction of more competition. At the same time, states will not undertake their own destruction by abolishing all regulatory authority, which strengthens states in many ways. Regulation allows states to maintain political control over firms that might be essential to national defense. It also allows states to engage in constituent service, whether by imposing controls on poorly organized groups, such as small businesses, in order to benefit well-organized groups, such as large businesses; or by creating exceptions to the rules for particular clients.[14]

This view of state interest and regulatory reform captures the cross-national commonalities that Vogel has uncovered. It explains why different countries have converged toward competition-promoting regulatory reform but not toward laissez faire.[15] The theory does not explain divergence among national approaches, however, since it deals only with the ends of states (revenue and discretionary power) without addressing the means states use to accomplish those ends. The means depend on the situation of the country in the international economy (open economies may be more constrained than closed ones); the socioeconomic structure of the country (a powerful landowning class may thwart the growth of manufacturing, or voters in a highly unequal class system may strongly favor redistributionist policies); institutional design (for example, separation of powers may block sweeping policy initiatives or comprehensive planning); and "regime orientation" (a fuzzy variable describing how state actors view the consequences of their policies—for example, a regime orientation toward corporatist macroeconomic compromise is often attributed to Germany). Vogel himself

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makes the case for this theoretical "division of labor" between factors explaining convergence and those explaining divergence.[16] Being more interested in divergence, Vogel focuses on the set of variables just mentioned, particularly regime orientation.

Regime orientation is malleable to changes in state actors' economic views. Thus, it might be fair to say that there has been a common shift in regime orientations toward the promotion of loosely defined "deregulation" and "liberalization" due to both the experience of regulation and the emergence of economic theories of regulation that emphasize the extent to which regulations are likely to serve special interests. However, regime orientations still differ among countries. Japan's approach to regulatory reform has obviously been more regulatory than Britain's and, arguably, has been less liberalizing (less effective in promoting competition). Both states are more-or-less consciously seeking the same ends—fiscal health and the ability to intervene when necessary—but the individual policy makers within each system have different ideas about how to achieve these ends. Apparently Britain's experience with labor-union militancy and widespread nationalization, combined with its old intellectual and political-economic heritage of market liberalism, caused Conservative (and New Labour) policy makers to see competition-promoting deregulation as the solution to long-standing economic problems, while Japan's apparent success with (relatively) state-led development gave Japanese policy makers reason not to want to scale back state authority.[17]

Vogel's claim that there has been no net loss of government control over industry worldwide, despite the perception of widespread deregulation, corresponds to the findings that capital mobility has not caused governments to cut taxes and spending, and that it has not provoked convergence in national tax and spending trends (Garrett 1998). But this does not mean that globalization has not been a source of regulatory reform (including some deregulation). If states make tradeoffs between fiscal stability and domestic control, then international economic competition, along with state officials' changing convictions about economic theory, may have made it seem necessary to reduce or restructure regulation—an element of domestic control—in the interest of fiscal health.

This would explain why, in a world of mobile capital, governments have not been forced to slash spending, taxes, and regulations. Even if by retaining taxes and regulations states lose some of their tax base, revenue maximization is not their sole goal. They will not abandon

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the various tools of intervention that allow them to promote national self-sufficiency in industries thought vital to national security; to satisfy the demands of domestic constituencies; and to reward friends and punish enemies, both domestically and internationally. (In countries where the population is particularly ignorant of political goings-on, and states are particularly desperate for legitimacy, they may even use tools of domestic regulation covertly to *create* problems and then ostentatiously solve them.) Furthermore, governments can compete for mobile capital by offering subsidies, not just tax breaks—as a perusal of economic competition among local governments in the United States reveals.

Globalization may, therefore, have prompted a great deal of regulatory change; but only when it has been coupled with policy makers' perception of either the fiscal benefits of enhancing international competitiveness through deregulation (see Borchert 1996), or with their belief that deregulation would serve the public good independent of state interests, has globalization led to a contraction of state authority.

NOTES

1. Other dissidents from the conventional wisdom are Geoffrey Garrett (1998) and Dani Rodrik (1998).
2. Vogel even goes so far as to say that "liberalization and deregulation contradict each other more than they complement each other" (65). This statement cries out for context; complete central planning of the economy would not be conducive to market-driven competition. Vogel's central paradox, evident from the title of the book, is that liberalization requires more regulation; but this is overstated. Immediately upon privatizing or removing monopoly privileges, governments often must actively promote competition with the firm that had been enjoying legal privileges for so long. On the other hand, when bureaucrats maintain their control over entry and price and production decisions indefinitely after the initial reform, regulation no longer assists liberalization but instead hinders it.
3. Privatization without deregulation does not necessarily decrease bureaucratic authority: in the limit case, regulation of privately owned firms can approximate straightforward state management. However, to code the replacement of state ownership with state regulation as an instance of "reregulation" is misleading.
4. See Abolafia 1985 for a detailed analysis of self-regulatory policy at the Chicago Board of Trade.
5. This is probably true of much regulation all over the world.

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6. According to Vogel, "it was falling behind its Continental neighbors in labor productivity, and it was lagging in the all-important race toward digitalization" (70). Furthermore, it was undergoing financial problems.
7. See Somin 1998 and Friedman 1998 for compelling accounts of pervasive public ignorance.
8. State strength and state autonomy are often conflated in the literature, but it is useful to keep the concepts analytically distinct. Logically, a state may be strong (i.e., stable) and yet not autonomous (i.e., it is penetrated by social forces and coalitions). Empirically, perhaps, state strength and autonomy are correlated, though the monarchies of the Arabian crescent may be examples of nonautonomous strong states.
9. I have so far avoided defining the state. However, I believe the evolutionary argument would apply to any organization that attempts to maintain an exclusive privilege of exercising violence within a given territory (Weber's definition). Of course, no state has a monopoly on violence within its claimed borders. About the best a state can accomplish is to secure the right to be the ultimate arbiter of what constitutes legitimate violence within a given territory (thus, a state can decide whether private violence is legitimate or not). The part of Weber's definition that is crucial to my argument is exclusivity. It is the state's attempt to be the exclusive arbiter or employer of force that generates the competitive dynamic among states.
10. See Przeworski and Wallerstein 1988.
11. For a historical example, see North and Weingast 1979.
12. My use of the term "institutionalization" is not much different from Samuel Huntington's (e.g., 1968, 5). Unlike Huntington, however, I do not wish to equate the state's interest and the public interest.
13. One way to do so is to take a random point in time and run a regression predicting the future survival of polities against their past survival. I have done this for European and industrial countries after World War II. The Pearson correlation between years before 1945 under 1945 constitutional arrangements, on the one hand, and whether the polity undergoes a fundamental constitutional change between 1945 and the present (1=change, 0=no change), on the other, is −0.00513, with a standard error of 0.002093 (p-value=0.02), indicating strongly that governments that have existed longer are more likely to survive in the future. Of polities in the sample that had existed for at least 20 years prior to 1945, none had undergone a significant constitutional change between 1945 and today except one: the Soviet Union. Of polities that did not yet exist in 1945 or were just being (re-)created, only Italy, Japan, Austria, the Netherlands, Belgium, Denmark, and Luxembourg have not since had a major constitutional change—and the latter four countries had an only recently dismantled administrative apparatus to reinstate, while the former three maintained new institutions under the watchful eye of foreign military observers. Though the sample includes only 30 countries, the data provide striking evidence that past state survival predicts future survival. It would be difficult to account for this finding without an evolution-

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ary theory of state strength, particularly since it directly contradicts the "rise-and-decline" theory, which holds that the longer a state exists, the more likely it is to become corrupt and to fall (e.g., Olson 1982).

14. See Olson 1982, 71, for an example of the latter phenomenon.
15. "Laissez faire" is, of course, a form of regulation aimed at establishing private property rights. But including laissez faire in the definition of "regulation" would make it impossible to speak coherently of "deregulation," which is a traditional usage in discussing the putative effects of globalization—as is the term "laissez faire."
16. Each of these forces for change—market shifts, the export of U.S. regulation, and macroeconomic changes—provides a partial explanation for the widespread movement toward regulatory reform in the advanced industrial countries. . . . These explanations account for the elements of convergence among the advanced industrial countries. . . . However, they cannot address the even more remarkable variance in how these countries have responded to these challenges. (41)
17. Borchert 1996 argues, in fact, that reform was a distinctly national and nationalist endeavor, undertaken to enhance the stature of the nation-state in global context.

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Deepak Lal

THE THIRD WORLD AND GLOBALIZATION

ABSTRACT: *Many in both developed and developing countries fear global economic integration. But developing-country fears of volatile capital flows are unfounded, as are developed-country fears of pauper wages due to low-cost imports. Demands for "ethical trading" are as misplaced as the fears of Third-World cultural nationalists that globalization will destroy their valued ways of life.*

Globalization[1] is the process whereby national commodity and capital (but currently, not labor)[2] markets are being internationally integrated. It continues a trend that was halted at the beginning of the twentieth century, when the liberal international economic order (LIEO) created under British leadership after the repeal of the Corn Laws broke down as a result of the two world wars and the Great Depression.

After the Second World War a new LIEO was constructed under U.S. leadership, first for trade in commodities, and then, gradually—as exchange controls were removed in most OECD countries—for the movement of capital. The developing countries that had participated in the first LIEO, however, by and large stayed out of the new LIEO until the debt crisis of the early 1980s, and the end of Communism in 1989, led them to abandon the inward-looking policies regarding both trade and capital flows that had been in place since the Great Depression.

The Asian financial crisis again raised questions in the Third World

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countries about the wisdom of the openness to globalization they so recently adopted. In this article I first examine the effects on the Third World of participating in the global economy, and then I turn to the fears globalization has generated in both developing and developed countries, particularly in light of the Asian crisis.

The Benefits of Globalization

The argument for free trade in both goods and capital is simple and powerful. For the inhabitants of each and every country, foreign trade expands current and future consumption possibilities by increasing the availability of foreign goods. Despite various attempts to find exceptions to this rule, the only one that has stood the test of time is the so-called "optimum tariff" case first adumbrated by J. S. Mill—but its practical relevance is severely limited.[3]

Britain was the first country to understand the case for free trade, which it adopted unilaterally in the mid-nineteenth century. Its example spread to much of the globe, and by about 1870, much of the Third World had also been integrated into the world economy—in many cases under the force of imperial arms. This led to intensive economic growth in many of these areas for the first time. Intensive growth, which leads to a sustained rise in per-capita incomes, is to be distinguished from extensive growth—where output and population grow in tandem, so that per-capita income is constant—which was the norm throughout human history.

One may further distinguish two types of intensive growth, Smithian and Promethean (Lal 1998b). The first occurs when gains from trade result from a widening market, as emphasized by Adam Smith. Historically, this occurred as areas with diverse resources were knitted (or forced) together into a larger common market, often through the use of military coercion, as in the Pax Greco-Romana, the Pax Islamica under the Abbasids, the Buddhist peace under the Mauryas in India, the Pax Tokugawa in Japan, and the extension of Sung rule to the Yangtze valley. But in these agrarian economies, as E. A. Wrigley (1988) has maintained, the possibilities for continued intensive growth always ran into the constraint of a fixed amount of land. The distinctive feature of the form of intensive economic growth engendered by the Industrial Revolution is that it provided a source of heat—charcoal—that substituted for products of the land, and a source of mechanical energy—fossil

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fuel—that substituted for animal and human muscle. As the capital inheritance represented by fossil fuels is enormous, it enabled Promethean growth to occur first in the West and increasingly in many parts of the Third World and now, finally, in China and India. The sustained increase in per-capita income that Promethean growth allows has meant that the ancient scourge of mass poverty may be eliminated within the span of a generation (Lal and Myint 1996).

In the nineteenth century the integration of the Third World into the global economy promoted both Smithian and Promethean intensive growth. Smithian growth was widespead: many countries in the tropics came to specialize in producing and trading the mineral and agricultural products demanded by the industrializing West. But some Third-World countries, most notably Japan and India, also began to industrialize during this period, shifting from agricultural to mineral energy-using economies and touching off potentially unlimited Promethean growth.

When the first LIEO broke down, however, most of the Third World attempted to promote Promethean growth through variations on the forced industrialization first pioneered by the Soviet Union. The mixed record in terms of both growth and the amelioration of poverty resulting from these inward-looking policies, as well as the final collapse of the Soviet model, have erased the intellectual respectability such policies once had. Meanwhile, the outward-looking countries of the Pacific Rim used foreign trade—but not always foreign capital—to achieve unprecedented growth rates and reductions in poverty. The confluence of the failure of *dirigisme* and the success of the Asian Tigers has led to the general acceptance in the Third World of what has been termed the "Washington consensus" on development policy. Even such stubbornly *dirigiste* countries as China and India have found that once they began the process of economic liberalization so as to integrate themselves into the world economy, their growth rates accelerated.

As with the first LIEO, the new one offers the developing countries the hope of both Smithian and Promethean growth, depending upon their relative factor endowments. Free trade is the "handmaiden" of both types of intensive growth, to use the late Irving Kravis's (1970) felicitous term. Direct foreign investment, which transfers technology and skills, is an important additional agent of Promethean growth. The increasing integration of world capital markets through portfolio flows, moreover, has put an ever-tighter lid on the fiscal predatoriness of states, as their tax take is now limited by the mobility of capital. Increas-

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ingly, the treasury or central bank may propose, but the global bond market disposes. This can only be beneficial, as states are increasingly forced to limit their "takings" to what is needed to finance the essential public goods that justify their existence.

Thus, if the new LIEO can be maintained, it offers the prospect (as did the first one) of a sustained period of universal prosperity and, perhaps, peace. But as in the late nineteenth century, there are many threats to the continuance of the benign processes of globalization.

Third-World Fears and the Asian Crisis

The major fear in developing countries is that continuing globalization, particularly in capital markets, will lead to greater volatility and thereby reduce economic growth. The Asian financial crisis, which took the stripes off so many of the region's Tigers, intensified this fear, but it goes back a long way. Its immediate progenitor was anxiety about the short-term instability inherent in relying on exports of raw materials. But in a 25-country study covering the period since the Second World War, Hla Myint and I (Lal and Myint 1996) could find no statistical evidence that volatility in short-term growth rates affected long-run growth rates. This conclusion is consistent with numerous studies of the effects of export instability on growth. Thus, Hong Kong has had some of the most volatile annual growth rates amongst developing countries, while India has had some of the most stable; but the long-run growth performance of Hong Kong puts that of India to shame. Although there is undeniably greater volatility in the national incomes of countries integrating with the world economy, this need not damage their long-run growth prospects.

Does the Asian crisis portend a new, more dangerous type of instability? To answer this question we need to briefly outline the three causes of the crisis: the exchange-rate regime; domestic banking systems under the Asian model; and the actions of the IMF.

The first cause of the crisis was the quasi-fixed exchange rates maintained by many of the affected countries. In a world with a globalized capital market, only two exchange-rate regimes are viable: one in which a currency floats freely, and one in which it is rigidly fixed. Only these alternatives allow automatic adjustment to external and internal shocks without the need for any discretionary action by the authorities (Lal 1994, ch. 6). In a world where a highly decentralized but integrated

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capital market instantaneously mediates these shocks, the authorities do not have the time or the means to obtain the information needed to make appropriate currency adjustments. They often end up doing more harm than good when they try to manage their exchange rates in the volatile and unpredictable global economy, as they can easily cause serious real exchange-rate misalignments.[4] An automatic adjustment mechanism is therefore preferable to a discretionary one.

In this context it is useful to see how and why the international monetary system evolved from the nineteenth-century gold standard to the quasi-fixed exchange rates of the Bretton Wood regimes, and to the mixed "non-system" that has since prevailed; and why, for the most part, deviations from floating rates cause most of the financial problems of the global economy.

Stable Currencies vs. Democratic Politics

The gold standard became the international monetary system in about 1870 largely because fixed quantities of gold were exchangeable for the currency of Britain—the leading economic, political, and commercial power.[5] The Achilles heel of the gold standard (which also bedevils its modern-day equivalent, the currency board) was the rise of fractional-reserve banking, which allowed banks to finance more loans than the amount they had on hand in the form of deposits. The problem with this system was the danger of bank runs. To stop them, the central bank needed to act as the lender of last resort. But this sometimes meant that it had to extend credit beyond the limits consistent with the rules of the gold standard. The expedient used was to break those rules in the short run while adhering to them in the long run.

This was possible because, before the advent of mass suffrage and the rise of labor parties and the welfare state, central banks needed to take account of no imperative other than maintaining long-run monetary stability, with full convertibility at the fixed exchange rate. Knowing this, foreign investors would invest capital in an economy with a faltering currency, hoping to gain from the eventual strengthening of the currency that they fully expected from the central bank. As Barry Eichengreen (1996, 32) puts it, "central banks possessed the capacity to violate the rules of the game in the short run because there was no question about obeying them in the long run." The end of these political circumstances, and the deflationary effect of a gold supply that was

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expanding much more slowly than real economic output, led to the Depression of the 1870s and the eventual unravelling of the gold standard.

The quasi-fixed exchange rate system set up at Bretton Woods was an attempt to resurrect a version of the gold standard. This attempt foundered, as freeing trade led to free capital flows that subjected the quasi-fixed exchange rate to speculative attack. The result was that capital tended to flee faltering currencies rather than bolstering them. Today, with the global financial market instantly integrated by computer, there is no way to control the massive flows of capital without isolating one's economy from the enormous benefits of foreign investment.

With the demise of Bretton Woods, the problem of capital flight was joined by the danger of speculative attack against quasi-fixed exchange rates, as changing economic circumstances require *real* exchange-rate adjustments that induce changes in domestic wages and prices. Such changes are, however, now likely to encounter domestic political opposition, to which modern governments—unlike those of the nineteenth century—are likely to succumb. Indeed, the expectation that the authorities will blink under the pressure of domestic politics induces capital to flow out in anticipation of a devaluation. This expectation was borne out by the experience of many otherwise well-managed East Asian economies in the recent crisis. But the same political pressures that cause these problems would render commitments to fixed exchange rates unsustainable, so floating rates seem to be the only possibility under present circumstances.

The second cause of the Asian crisis was a systemic flaw in the "Asian model" of development. As seen most clearly in Korea but presaged by the development of Japan, this model closely linked the domestic banking system, industrial enterprises (particularly the biggest of them), and the government. In Korea, the government channeled subsidized credit to *chaebol* whose performance was judged not by market tests, but by adherence to bureaucratically determined export targets.

Korean *chaebol*, like Japanese *zaibatsu*, were government creations designed to help make the transition from the simpler manufactures, which can be produced by family-owned enterprises, to more complex products that require large and lumpy capital investments—beyond the financial means of owner-managers. There have been three routes to the requisite separation of ownership and management in the absence of developed domestic capital markets: public-sector industrialization, as

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in Taiwan and India; direct foreign investment, as in Singapore; and the political creation of concentrations of private wealth in the form of state-subsidized family conglomerates, as in Korea and Japan.

The Korean/Japanese route can be fairly effective, as local mandarins, who have no way of affecting the foreign sales of the favored conglomerates, therefore cannot corrupt the distribution of subsidized credit, which is determined by adherence to export targets. Hong Kong, however, which relied on private forces of growth, enjoyed the highest efficiency of investment amongst the Gang of Four.[6]

The danger in the Korean/Japanese system is that, by making the banking system the creature of the government's will, it produces tremendous moral hazard in the domestic banking system. The banks have no incentive to assess the creditworthiness of their borrowers or the quality of the investments their loans are financing, since they know that no matter how risky and overextended their lending, they will always be bailed out by the government. This can lead in time to a mountain of bad debt and the de facto insolvency of a major part of the banking system, as has happened in both Korea and Japan.

Moral hazard in domestic banking systems under the Asian model has been aggravated by the actions of the IMF, combined with the entrance of foreign bankers. Foreign bank loans are usually denominated in dollars, so if the local currency depreciates relative to the dollar, local debtors become less able to match their income in domestic money against their dollar-denominated debt. Under normal circumstances, the resulting risk of default would limit foreign lending. But ever since the debt crisis of the 1980s, foreign banks facing defaults on their Third-World debt have argued that this poses a systemic risk to the world's financial system, and have demanded international bailouts to prevent such a catastrophe. The IMF has been more than willing to oblige, evolving from the manager of the now-defunct Bretton Woods system into the international debt collector for foreign banks, as well as an important tool of U.S. foreign policy.

The crisis in Indonesia provides the clearest example of the metamorphosis of the IMF. Before the Thai crisis hit the region, the Indonesian economy had been fairly well managed despite the "cronyism" of its brand of capitalism. It had provided exceptional growth rates, with a sensible deployment of its oil revenues—unlike, for instance, Nigeria—and had made an impressive dent in Indonesian poverty.[7] At the time of the Thai crisis, Inodnesia's economic funda-

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mentals were sound: it did not have a massive trade or budget deficit, it had a flexible exchange rate, and its debt burden was not onerous.

In reaction to the Thai crisis, however, the foreign banks that had lent to the Indonesian private sector called in their loans, leading to a depreciation of the rupiah and a massive increase in the domestic currency costs of servicing foreign-currency-denominated loans. Normally, many of the borrowers would have had to default, hurting the mainly Japanese and American lenders. But enter the IMF. Under pressure from the governments representing these lenders, the Fund deemed such defaults too risky to the world financial system; so, in effect, it forced the Indonesian government to assume the bad debts. IMF funds will repay the foreign lenders, and the Indonesian government will have to repay the IMF out of its tax revenues. Thus, the Indonesian people are required to bail out the foreign banks.

With the increasingly confident expectation that they will be rescued by the IMF no matter what the quality of their lending to Third-World countries, international banks have, since the 1980s, lost all incentive to exercise prudence. When this international moral hazard is mixed with the domestic moral hazard associated with the politicized banking systems of the Asian model, the result is a disastrous witches' brew. Foreign and domestic banks alike know they will be bailed out if they overlend, so they have no reason not to do so, raking in interest on their loans in the meantime.

First-World Political Opposition

In the developed countries, the major threat perceived from globalization is that trade with the Third World will undermine the wages of less-skilled workers—and their mass unemployment, as in Western Europe. Whether this threat is real is a matter of ongoing debate. But it is more than conceivable that the problem is a massive structural change that is as momentous as the Industrial Revolution. Sir John Hicks (1979) characterized the dominant feature of the Industrial Revolution as the substitution of fixed for circulating capital, as the factory replaced the putting-out system. The current structural revolution can be characterized as replacing fixed with human capital, as epitomized by the communications revolution in the West.

While many of the larger Third-World countries increasingly have a comparative advantage in heavy industry, in the production of con-

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sumer goods the current tendency is toward different versions of the same product so as more closely to tailor it to different individual tastes. Variety rather than standardization is the name of the game in the affluent West, accommodating shifts in consumers' variegated preferences. A new international division of labor—reminiscent, in fact, of the old putting-out system—is emerging, in which design capacity, which is human-capital intensive, is located primarily in the richer countries, which use modern telecommunications to convert their designs into differentiated consumer goods.

The predictable result of this new industrial revolution is stagnation in the wages of the unskilled—and rising unemployment where wages are kept artificially high, as in Europe. These results should motivate workers to acquire human capital (e.g., education), and once they do, their standard of living should start to rise again. But this process will take time (even in nineteenth-century Britain, during the first Industrial Revolution, it appears that living standards took a long time to rise as, for instance, the handloom weavers of the putting-out system became the factory workers of the modern age). While this change is taking place, the voices of various forms of economic nationalism will try to mobilize political proponents of support to preserve old ways of making a living by blaming the plight of the low-skilled on globalization. The protectionist results of such political pressures can easily encourage—and be encouraged by—the economically uninformed sympathy of more affluent First-Worlders for the plight of Third-World sweatshop workers. By using international organizations, trade sanctions, and "ethical investing" to impose "humane" labor and environmental standards on the Third World, compassionate residents of the First World unintentionally rob the world's poorest of their comparative economic advantage and doom them to continued poverty by pricing them out of the world market.[8] And since the real beneficiaries of such policies are the relatively well-off low-skilled workers of the West, it is not unlikely that Third-World politicians will be able to mobilize popular support by depicting globalization—that is, globalization as modified by First-World politics—as a conspiracy against the Third World.

Globalization and Religious Cosmologies

Third-World economic opposition to globalization may find ready allies among those in the Third World who view globalization as a form

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of cultural imperialism that undermines their ancient and cherished ways of life.

People's ways of life are ultimately grounded in what I will call their cosmologies: their views of the purpose and meaning of life.[9]

The great Eurasian agrarian civilizations had more similarities than differences in their cosmological beliefs, which can broadly be described as "communalist." The hunter-gatherer whose egoism would have been tempered only by the reciprocal altruism that stems from playing repeated Prisoners'-Dilemma games with the same people would be dysfunctional in the new environment of settled agriculture, which increased the size of social groups and thus the number of strangers one would encounter. As if to reduce the resulting cost of policing transactions, which would have dissipated the mutual gains from cooperation, agrarian civilizations internalized restraints on antisocial action through cosmologically based moral codes that, when inculcated from infancy, made people ashamed to act against the interests of the community. Similarly, commerce that is motivated by unmodified self-interest also threatens communal bonds, so agrarian civilizations took a dim view of merchants and markets, tolerating them as at best a necessary evil. In both of these respects, the cosmologies of agrarian civilizations were not conducive to promoting intensive economic growth.

I have argued elsewhere that the rise of the West depended on its break from this agrarian past, as a result of the twin revolutions of Pope Gregory the Great in the sixth century and Pope Gregory VII in the eleventh century (Lal 1998b). The former inadvertently promoted the independence of the young. Subsequently, however, the Church reacted against the individualism Gregory the Great had triggered by emphasizing Original Sin in a manner that kept antisocial behavior in check by means of guilt. It was only much later, with the Scientific, Darwinian, and Sexual revolutions, that Western morality began to deviate radically from its agrarian cosmological roots.

Gregory VII brought the Church into the world with his proclamation that the authority of the Church trumped that of the state. Eventually—and, again, unintentionally—the church-led state created the legal, commercial, and institutional infrastructure for a market economy and Promethean growth.

The effects of the two papal revolutions need not be conjoined, as they happened to be in Europe. The institutional modernization that, in Europe, stemmed from Gregory VII's innovation can now be brought about through the deliberate adoption by the Third World of

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market mechanisms, while the cosmological modernization inaugurated by Gregory the Great's reforms need not be accepted. The prospect of becoming wealthy without losing their souls is therefore open to non-Western cultures.

Among the features of Western culture that may thereby be rejected are individualism, universalism, egalitarianism, and the democracy that flows from these values. Christianity and Islam (and, in some respects, Judaism) differ from the other great Eurasian religions in demanding the free individual acceptance of religious doctrine; in proselytizing for the accepted doctrine; and in positing a single God, compared to whom all men are spiritual equals. If economic globalization is psychologically linked to the Western cultural agenda that descends from these distinctive features, there will be all the more reason for the Third World to reject it.

* * *

The newly resurrected liberal international economic order promises unprecedented prosperity for the entire globe. But its triumph is even less assured than was that of the first LIEO: the modern states in whose hands its fate rests are much more susceptible to popular pressures that might strangle its growth. The globalization of the economy is by no means inevitable. First it has to survive the politicization of society.

NOTES

1. This article is based in part on three earlier articles, Lal 1998c, 1999a, and 1999b.
2. There is unlikely to be a restoration of the free mobility of labor that characterized the nineteenth-century LIEO, as immigration controls are now ubiquitous—largely because the welfare state has created property rights in citizenship. This naturally leads to restrictions on immigration, since immigration creates new citizens with an automatic right of access to the resources of existing citizens through the transfer state.
3. The optimum tariff aims to turn the terms of trade in a country's favor, so that it can garner a larger share of the cosmopolitan gains from free trade. But if other countries retaliate, the shrinking of these cosmopolitan gains in a trade war may well leave the country initiating it worse off than it was before levying the optimal tariff. See Lal 1983 for a discussion of various arguments for *dirigisme* and why they have been found wanting.
4. The real exchange rate is defined as the ratio of the domestic price of traded to nontraded goods. The price of traded goods is determined by the nominal

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exchange rate, linking it to the real exchange rate. In adjusting to shocks, it is changes in the real exchange rate that are relevant, but these are not under the control of the authorities, who can, in a managed exchange-rate system, merely affect the nominal exchange rate. See Lal 1997, 144–47, and Lal 1994, ch. 13.

5. Eichengreen 1996 provides a succinct history of the international monetary system.
6. See Lal and Myint 1996, ch. 3 for details.
7. See Lal and Myint 1996.
8. See Lal 1998b.
9. See Lal 1998a.

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Garett Jones

"THE FREE MARKET" AND THE ASIAN CRISIS

ABSTRACT: *The Asian financial crisis, which devastated many of the newly industrializing countries, is said to have demonstrated the inherent fragility of economies built upon laissez-faire principles. However, it appears that the major sources of disruption have come from policies that deviate from laissez faire, such as government-guaranteed bailouts and international monetary policy. That* capitalist *economies were afflicted by the crisis does not constitute an indictment of* free markets.

Was the Asian financial crisis a failure of "the global free market"? Some have argued that it was; this faction includes George Soros and Prime Minister Mahathir of Malaysia, who declared in the midst of the crisis that the world's governments needed "to bring order to the market" (Saludo 1998). The anti-"laissez faire" chorus also includes several economists, such as Paul Krugman (1998a). All of these opponents of what Soros calls "market fundamentalism" contend that the hypermobility of financial capital had a destabilizing effect on developing countries by allowing stampeding investors to bring about severe economic dislocation.

Others have maintained that such claims are misplaced, and that the problem in Asia wasn't that the financial markets were too free; rather, markets were distorted by too much government interference. In this view, investors felt safe pouring money into developing Asian

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economies because they had learned, especially after the 1995 Mexican peso crisis, that government agencies, including the International Monetary Fund (IMF), would come to the rescue if investments turned sour. This expectation, referred to as "moral hazard," encouraged foreign investors to put their money into international investments after only minimal research: this was prudent, since government and quasi-government agencies were thought to be implicitly guaranteeing a fairly safe rate of return. And with so much capital flowing in, Asian businesses invested in projects that they would have rejected had funds been dearer. By 1997, however, investors came to realize that they were unlikely to earn the lofty returns they had expected, and so they pulled their money out, bringing financial ruin.

Are either of these analyses on target? Fortunately, economists and other international specialists have spent an enormous amount of energy trying to understand the causes of the Asian financial crisis, and have come to some tentative conclusions. However, the overarching historical issue of whether free-market policies per se caused the crisis has been somewhat obscured by economists' preoccupation with policy analysis and advocacy.

In order to shed some light on the historical issue, I will begin with a brief narrative of the crisis, review some of the leading research on its causes, and then explain why it does not appear to be attributable to laissez faire.

The Asian Financial Crisis

The crisis started with an attack on the Thai baht, leading to its devaluation on July 2, 1997. Until then, the baht had been pegged to the U.S. dollar. Thailand's devaluation occurred even though the country held more than enough foreign reserves to convert its entire monetary base (bank reserves plus baht in circulation) into hard currency. Indeed, all of the countries where the crisis hit hardest—Thailand, Malaysia, Indonesia, and South Korea—held foreign reserves in excess of 90 percent of their monetary base plus all checking deposits.

After the baht devalued, investors speculated that other countries with economic situations similar to Thailand's, and countries that competed with Thailand in export markets, might also be quick to devalue. (The same search for similarities apparently occurred after the Mexican peso crisis of 1995; see Sachs, Tornell, and Velasco 1996.) At the time

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(and even today) economists weren't sure which perceived similarities with Thailand drove the bulk of the devaluation speculation in other countries, although the countries that devalued their currencies the most tended to have either a low ratio of foreign currency reserves to domestic, dollar-denominated short-term debt (emphasized by Radelet and Sachs 1999), or a high percentage of nonperforming loans—a possible indicator of future government-financed bank bailouts (emphasized by Burnside et al. 1998). Either of these problems could require a currency devaluation, although for completely different reasons.

Why would speculators think devaluations likely in countries that competed with Thailand in export markets? Investors are well aware that prices are slow to adjust to currency fluctuations, so that once Thailand devalued its currency, it would be temporarily easier for Thai firms to sell their now-cheaper goods to their customers both inside and outside of Asia. This would make competition tougher for, say, Malaysian firms competing in the same markets. If prices were perfectly flexible, mere exchange-rate changes would have no competitive impact; but since prices adjust sluggishly, Malaysia's exports became relatively less appealing compared to Thailand's on the day of the baht's devaluation. This was one of many forces encouraging the Malaysian government to devalue *its* currency, the ringgit; and speculators, knowing this, found it appealing to sell their ringgit to Malay banks for dollars immediately, in hopes of getting more ringgit after the predicted devaluation (Goldstein 1998).

What was predicted for Malaysia occurred there and in Singapore, Korea, and Indonesia. Much of the trade in these countries was domestic or was with other countries in Asia, so that even if a firm's level of sales remained unchanged after devaluation, the proceeds from those sales would be in the form of suddenly less-valuable Asian currencies. Businesses in these countries, however, had built up billions of dollars in dollar-denominated debt in the years of enthusiastic foreign investment. After the devaluations, such businesses had to repay their short-term loans in suddenly more-expensive dollars. Hence, the devaluations led to a deterioration in the balance sheets of many companies, with a greater proportion of their cash flow dedicated to debt repayment.

In response, many foreign investors called in or chose not to renew their short-term loans to firms in the affected countries. As these countries depleted their foreign-exchange reserves in attempting to defend their currencies, investors—concerned with both the inherent risk of their investments and the risk that they would soon be unable to turn

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them into hard currency—pulled out en masse. Many Asian firms quickly found it difficult to sustain those of their day-to-day operations that had been financed with short-term lines of foreign credit. The withdrawal of foreign credit thus led to a widespread inability to meet payrolls and buy raw materials, devastating the Asian economies. Many firms quickly shrank, and others went bankrupt. Unemployment rates skyrocketed, and some Asian economies—that of Hong Kong, for example—experienced their first recession in decades.

The Free-Market Panic Thesis

The foregoing summary of events has only hinted at possible causes of the crisis. One batch of explanations contends that the various crises were, in effect, circular: they happened because investors thought they would happen, and not (primarily) because of any fundamental weaknesses in the economies. This explanation is compatible with the view that free-market capitalism is inherently prone to instability caused by speculative frenzies.

Jeffrey Sachs (1997) is the best-known proponent of the circular panic model. In *The New York Times* he put it this way:

> The Asian crisis is akin to a bank run. Investors are lining up to be the first out of the region. Much of the panic is a self-feeding frenzy: even if the economies were fundamentally healthy at the start of the panic, nobody wants to be the last one out when currencies are weakening and banks are tottering because of the rapid drain of foreign loans.

The power of this crisis-as-bank-run model lies partly in its familiarity: images of people standing in line outside U.S. banks during the Depression spring immediately to mind. We all know that the merest rumor of a bank's insolvency can sometimes bring about a bank run, especially in countries without deposit insurance.

Economists have some broad ideas about how bank runs are caused—everyone wants their money now, but only a small percentage of deposits are kept as currency—and how they can be cured: for example, with massive infusions of cash from the central bank. (The canonical model is Diamond and Dybvig 1983; an extension to the Asian crisis is Chang and Velasco 1998.) For the Asian crisis to be like a bank run, we need merely to relabel two elements of the model: for in-

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dividual banks, substitute the central banks of each country; for bank depositors, substitute foreign investors who changed their dollars into, say, baht in order to fund their investments in Thai firms, and who then suddenly wanted their dollars back from the Thai central bank.

There is no international parallel, however, to the lender of last resort—the central bank that saves the day in the bank-run scenario; for at the international level, there is no agency with enough dollars to repay foreign investors. Once the "bank run" begins, in anticipation of devaluation, devaluation itself becomes almost unstoppable. Like a self-fulfilling prophecy, a bank run that starts for no reason makes the bank unsound for no reason other than the run itself; like a bank run, the expectation of devaluation, even if initially groundless, makes a previously sound economy unsound by inducing investors to withdraw their capital, causing a financial crisis; and, like a bank run, a financial panic can be prevented only if investors are confident of a "central-bank" bailout.

However, the historically inclined reader should question the notion that bank runs are inevitable in the absence of a central bank willing to print money. (The theoretically inclined economist will also object to this notion, although for different reasons). Private banks in the United States and other countries had tools to deal with bank runs long before central banks existed: when a panic struck, private banks would agree to lend money to their troubled competitors, as long as the troubled banks appeared to be fundamentally sound (see Calomiris 1998). These guarantees made bank runs less likely, and often stopped bank runs once they began. So in Asia, why didn't large financial firms or other countries come to the rescue of the troubled economies, just as Walter Bagehot urged a century ago, lending "freely, at penalty interest rates, on appropriate collateral" (quoted in Feldstein 1999, 94)?

The answer to this question has led to an entire literature in international macroeconomics concerned with (roughly) how high interest rates will go in a country in crisis before it decides to give up on defending its currency and simply devalue (e.g., Obstfeld 1996). Raising interest rates by pulling domestic currency out of circulation is the classic way to defend a currency. By paying a higher interest rate, the country in crisis makes it more appealing for investors to keep their money there and bring new money in. But high interest rates have an enormous cost: by raising domestic firms' interest payments, their investment is curtailed, and so, indirectly, are domestic consumption and employment.

These features can be a source of self-fulfilling currency crises: if in-

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vestors know that a country would be unable to defend its exchange-rate peg if it were fiercely attacked, then whether a devaluation occurs depends entirely on whether investors decide to exchange the currency for another one. This is why countries such as Hong Kong and Taiwan, which had foreign-exchange reserves that dwarfed those of Thailand, Indonesia, Malaysia, and South Korea, made poor speculative targets.

While Thailand, Malaysia, Indonesia, and South Korea had fewer foreign-exchange reserves than some of their neighbors, the weaknesses of their banking sectors also appear to have contributed to speculators' suspicions. Problems of moral hazard and weak financial systems have been common in the developing nations of Asia, and may have played a major role in the crisis.

Asia's Politicized Economies

The IMF's bailout of Mexico during the 1995 peso crisis may have encouraged investors to set aside reservations about investing in the developing countries of Asia, but if we want to explain the devaluations themselves, a bigger culprit appears to be the fact that "politically connected individuals or institutions—Thai finance companies, members of the Suharto family, *chaebol*-controlled banks—were widely perceived to be backed by implicit government guarantees" (Krugman 1998b). When the IMF bails out investors, it pays them in hard currencies. The Asian governments, however, could back up *their* implicit guarantees only by running budget deficits to bail out investors—deficits that would likely be paid off via the printing press.

The perverse incentives that the IMF provided surely added to the overall level of indiscriminate investment, but it appears to have been the unwritten guarantees provided by Asian governments that convinced investors that the printing presses would soon be starting up. As investors began to see a lot of bad debts accumulating, they began to fear that Asian governments were going to have to make good on their unwritten guarantees. This caused the relevant currencies to fall in perceived value, putting irresistible downward pressure on the exchange-rate pegs.[1]

Craig Burnside, Martin Eichenbaum, and Sergio Rebelo (1998) have pursued this line of thought. They start by observing that while the four Asian countries they study (Korea, Thailand, the Philippines, and Malaysia) had abundant hard-currency reserves, these countries'

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banks held many nonperforming loans, and their financial sectors had declining stock valuations during the years before the crisis; these declines ranged from 34 percent in the Philippines to 92 percent in Thailand. While nonfinancial stocks took a beating in all four countries, bank stocks performed far worse. Burnside et al. infer that investors expected governments to bail out the firms that owed money to the banks—not the banks themselves—by printing money and handing it to indebted firms. (Equivalently, the governments could be expected to make loans to these firms at below-market rates, with easy repayment schedules; either method would boost the money supply, devaluing the currency.) Had investors expected governments to insure the banks themselves, then the stock-market outcomes should have been reversed: financial stocks should have done better than nonfinancial stocks.

Part of this model's appeal is that it doesn't require that devaluation occur as soon as bad news about banks hits investors. This fits the observed data, since no big news occurred in the days before the speculative attack on the baht. However, the model also relies on a lot of guesses about unobserved variables regarding such factors as governments' unwillingness to raise taxes rather than print money and the exact timing of the devaluations. But since it captures some key elements of the Asian crisis, and usefully links the devaluations with the weakness of the banking sector, it is a model worth keeping in mind. Perhaps future research will reveal whether key investors believed a bailout was coming. If so, then the weaknesses of these banking systems, combined with the prospect of government bailouts, would seem to explain the devaluations.

What about the recessions that followed devaluation? Many researchers, including Barry Eichengreen (1999), have concluded that the dollar-denominated debts of Asian businesses played a crucial role. With their locally or regionally derived revenue suddenly devalued, more of it had to be paid to foreign debtholders, diminishing Asian firms' future profitability and, therefore, making loans to them less appealing for prospective lenders. With fewer loans, less output can be produced. The question is, why did foreign investors make so many loans to companies in vulnerable countries in the first place?

Recent work by Burnside et al. (1999) demonstrates that a government's implicit guarantees, combined with a fixed exchange rate, can lead foreign investors to overlend quite rationally. Once this moral hazard-inspired overlending reaches a critical point, the currency devalues,

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firms' balance sheets are severely damaged, and output and employment decline.

Global Capitalism Isn't Global Laissez Faire

So: was the Asian crisis caused by global capitalism, or by the interventionist tendencies of Asian states and the state-controlled IMF? The short answer is Yes. The depth and severity of the Asian recessions—and possibly even the recessions themselves—were proximately caused by the free international flow of short-term financial capital, which fled when things turned sour. If the Thai, Malaysian, Indonesian, and South Korean governments had restricted global capitalism by limiting short-term financing from abroad (as Chile, for example, had done a decade before), and if they had met their short-term financing needs from domestic sources, then the mere devaluations of their currencies would not have trapped them in a liquidity crisis that soon turned into a solvency crisis. They never would have had to try to get their hands on tens of billions of dollars within a matter of days or weeks, and their dollar-indebted firms would never have been forced into bankruptcy.

On the other hand, extremely important deviations from laissez faire had already occurred, and seem to have been critical in causing the crisis. High levels of short-term, private-sector debt were an important precondition for the crisis (e.g., Uchitelle 1999). These high levels of debt appear to have been encouraged by governmental and quasigovernmental agencies that provided implicit bailout assurances. This form of state intervention—combined with mismanagement by government-empowered central banks, pegged exchange rates, and low levels of foreign exchange—appears to have engendered the perceived danger that began the crisis.

High levels of short-term debt alone were not a sufficient condition for a massive financial crisis, as the Singaporean experience shows. Singapore's foreign exchange holdings were massive (deterring a currency run), and it already had acquired a reputation for having a "transparent" and relatively laissez-faire financial system (minimizing concerns over moral hazard). As a result, it had to weather merely a decline in its growth rate, while its neighbor, Malaysia, suffered a 7-percent drop in output.

There was an element of market-driven, self-fulfilling prophecy at work. But it is simplistic to conclude that this makes the crisis a prod-

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uct of free markets. The global "free market" is hardly an arena of unmitigated laissez faire. If anything, it was state failure, not market failure, that produced the Asian crisis.

A free flow of short-term international capital was undoubtedly a necessary precondition of the Asian financial crisis. However, this particular laissez-faire aspect of global capitalism was not sufficient to cause the crisis. Indeed, were it not for *political* failures both global (IMF) and local (pegged exchange rates, low levels of foreign exchange), the flow of capital would simply have continued to alleviate Asia's poverty, as had been the case before the crisis.

NOTE

1. It's possible to make too much of the moral hazard argument. As many commentators have noted, real (inflation- and exchange-rate adjusted) interest rates were higher in the "Asian tigers" than in the developed world. Ordinarily, economists and financial analysts believe that there is a tradeoff between risk and return: a higher return on investment compensates the investor for taking a higher risk. But in the absence of moral hazard, they would have been even more nervous, and therefore more cautious. High Asian interest rates indicate that investors must have been at least a little nervous about the risks involved.

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Kevin Dowd

ARE FREE MARKETS THE CAUSE OF FINANCIAL INSTABILITY?

ABSTRACT: *As the critics of global financial capitalism recognize, there is excessive financial instability in today's international economy. However, this instability is due not to laissez faire, but to its absence. Comparing the current world financial system to a laissez-faire benchmark highlights the very significant differences between the two.*

Most observers would agree that there is something wrong with the world financial system. There is far less agreement on what the problems are, but two claims in particular come up repeatedly whenever the subject is raised.

The first is that financial markets are in some sense excessively volatile: that financial prices fluctuate more than is socially desirable because of inherent weaknesses in how financial markets operate. Different arguments to this effect have been applied to many different financial markets—including the markets for bonds, equities, foreign exchange, commodities, derivatives, and the financial system generally—by many different writers, including H. P. Minsky (1972), Charles Kindleberger (1978), and, more recently, George Soros (1994, 1998).[1] To quote Soros (1994, 322–23):

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> Instability . . . can give rise to sudden reversals that may take on catastrophic proportions. . . . The prevention of excessive instability is therefore a necessary condition for the smooth functioning of the market mechanism. It is not a condition that the market mechanism can ensure on its own. On the contrary . . . unregulated financial markets tend to become progressively more unstable. . . . Excessive instability can be prevented only by some sort of regulation. . . .

A second, related argument is that too many resources are used up in financial activities, relative to the broader social interest. This claim, too, comes in many different forms: that there is too much financial speculation, that there is too much financial trading activity, that too many resources are devoted to managing financial risk, that derivatives serve little or no socially useful purpose, and that the financial-services sector is too large relative to the real economy.

Both types of argument are couched as criticisms of financial-market failures; in reply, free-market economists often deny that there are any real problems at all. Both sides in these debates share an important, and usually hidden, assumption: that the global economy exemplifies financial laissez faire. To give but one example, Soros (1994, 323) characterizes a world financial system with the new regulations he would like to see enacted as "a nearly free-market system," thereby suggesting that what we have now is a *totally* free one. For their part, free-market economists often respond to this sort of argument by defending a very questionable status quo. One side rushes to attack financial markets; the other side rushes to defend them; but both sides beg the key question: the extent to which the current world financial system is a genuine case of laissez faire.

A Laissez-Faire Financial "Architecture"

To answer this question intelligently requires picturing what a laissez-faire financial system would probably look like.[2] Laissez faire would mean no central banks, no financial regulatory agencies, and no other government intervention in the financial system anywhere in the world. There would be no international quasigovernmental financial agencies: no IMF, no World Bank, no Bank for International Settlements, and so forth. Market agents would be free to make whatever financial contracts they wanted, subject only to the general provisions of

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contract and commercial law (i.e., there would be the usual enforcement of contracts, prohibitions against fraud, and the like).

Under laissez faire, banks would be free to issue whatever currencies they wished, but it is reasonable to assume that competition would force them to make their currencies convertible more or less on demand.[3] For the same reason, it is likely that the values of different currencies would also be tied to the values of specific baskets of goods and services—"anchors" that would reassure consumers by tying down the value of the currencies they chose to use. The holders of bank currency would then have the right to convert their currency holdings not only into other currencies, but into redemption media of the same value. If a particular bank issued a note or made a deposit denominated in a unit called a dollar, the holder of this note or deposit would be able to require the bank to convert this holding into some other asset—a lump of gold, or whatever—of the same value. Banks that failed to provide this insurance against depreciation would be driven from the field.

Each anchor would likely be chosen to stabilize some target price index (such as the Consumer Price Index in the United States).[4] The anchor would determine the currency's price level and inflation rate, and would be a major influence on its exchange rates with other currencies.

The world monetary system might consist either of a single world currency or a group of different currencies, each dominant in some particular part of the world. Logically, there would have to be at least one primary currency unit tied to a commodity anchor; those units that were not specifically tied to such anchors would be tied to currency units that were so tied at fixed rates of exchange. All currency units would thus be directly or indirectly anchored. If there were only one primary currency unit, we would have a regime of permanently fixed exchange rates reminiscent of the postwar Bretton Woods system, in which other currencies were tied to the dollar, and the dollar was tied to a fixed quantity of gold.

If there were more than one primary currency unit, each fixed to its own commodity anchor, the exchange rates between the primary currency units would fluctuate with changes in the relative prices of the anchors. However, these anchors would tend to have fairly stable relative prices, if we assume that each anchor is chosen to stabilize some consumer price index. Exchange-rate shifts among anchored or primary currencies should therefore be relatively small and infrequent. Other currencies, if any, would, for just that reason, almost surely be

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tied to one of these primary currencies. The same competitive pressures that would tend to tie primary currencies to commodity anchors would tend to tie any satellite currencies to some primary currency—and also to any other satellite currencies tied to the same primary unit—by means of a fixed exchange rate. The result would probably be a series of currency blocs, each a network of fixed exchange rates based on a primary currency, with exchange rates between these various blocs fluctuating slightly against each other.

Laissez faire, then, would probably give us one of three possible monetary arrangements: a single currency used throughout the world, and tied to a specified commodity anchor; a system of fixed exchange rates, in which all other currencies are tied to one key currency anchored to a particular commodity; or a system of fixed-exchange-rate currency blocs fluctuating slightly against each other, each tethered to a particular anchor. All such currencies would tend to be fairly stable in value, because the anchor(s) would have to be chosen to minimize price-level instability if they were to gain customer loyalty.

Today's Global Capitalism Is Not Laissez Faire

The fact that a laissez-faire monetary system differs so radically from our own should demonstrate the inaccuracy of the notion that the status quo is a financial free market. The economic instability recently produced by violent exchange-rate movements can hardly be blamed on "the market" when it is governments that control monetary policy.

There are, of course, some similarities between contemporary financial capitalism and a laissez-faire global financial market. Several governmental currencies—the dollar, the yen, and the mark (and, more recently, the euro)—are widely used and are, to a certain extent, independent of each other. The remaining currencies tend to be aligned with one of these primary currencies, with degrees of alignment varying from fully fixed exchange rates to exchange rates that are kept within some target zone. However, none of the existing currencies is tied to any commodity anchor, so there is nothing to minimize price-level and exchange-rate instability. Instead, the price levels of these different currencies depend on the monetary policies of the central banks concerned, and the central banks and/or the governments that control them have considerable choice in the monetary policies they pursue.

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Under laissez faire, there would be no link between a currency unit and a nation-state, and no reason for currency areas to match national territories. Since there are considerable benefits when people use the same currency unit (e.g., lower accounting costs and no currency-exchange costs), we might expect laissez-faire currency areas to be larger on average than present nation-states, and also better aligned with economic fundamentals such as trading patterns. This line of reasoning suggests that there would be fewer separate currencies under laissez faire and possibly a single currency area spanning the whole world.

Even if it fell short of cosmopolitanism, however, a global laissez-faire regime would tend to produce a high degree of price-level stability because the anchors would have to be chosen specifically for that purpose. It would thus tend to avoid the many (and very significant) costs of both inflation and inflation uncertainty.[5] Interest rates freed of speculation about possible inflation would move only in response to perceived changes in "real" factors. A laissez-faire regime would therefore tend to deliver fairly stable interest rates and so lead to fairly stable bond prices. The absence of inflationary shocks and the greater stability of interest rates would make the prices of stocks, shares, real estate, and other assets more stable as well.

By contrast, the current regime, cut loose from any anchor, offers no safeguards against inflation. If anything, it appears to have a built-in inflationary bias,[6] leading to erratic interest and inflation rates and very high levels of inflation uncertainty, especially over the long run.[7] Shifts in central-bank monetary policy have sometimes led to major (and often unexpected) changes in inflation and interest rates, a case in point being the drastic rise in interest rates in the United States when Federal Reserve policy shifted abruptly in October 1979. Governments often have incentives—such as those created by workers locked into wage contracts based on particular inflation expectations—to renege on past inflation targets, so as to take advantage of private-sector agents (see, e.g., Barro and Gordon 1983a and 1983b). To make matters worse, once private agents anticipate that the central bank might later change its policy, the credibility of policy targets erodes and produces even greater inflation uncertainty.

Inflation also leads to considerable asset-price volatility, with longer-term assets particularly unstable due to their greater sensitivity to changes in interest rates. Frequently, inflation also leads people to switch from paper assets such as government debt to real assets such as equity and real estate, fueling boom-bust cycles in real assets. All these effects

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have major (and often adverse) effects on investment, the capital structure, employment, and the economy more generally.

The stability of exchange rates under laissez faire contrasts sharply with the exchange-rate volatility experienced under current monetary arrangements, especially since the breakdown of the Bretton Woods system in the early 1970s. The adoption of the current fiat monetary arrangement has effectively made many exchange rates anchorless. Their value depends on monetary politics and expectations about it, both of which can be very unstable. As a result, exchange rates have often fluctuated very considerably, with adverse—and sometimes disastrous—economic consequences.

Interventionist Instability

The excessive instability created by the current monetary regime has many harmful consequences. It exposes almost everyone to unnecessary risks from price-level volatility (e.g., the risk of being locked into longer-term contracts at inappropriate prices); interest-rate volatility (e.g., the risk of losses on bond and bond-derivative positions, and the risks associated with the prospect of obtaining future financing at uncertain interest rates); exchange-rate volatility (e.g., the risk of losses on positions denominated in foreign currencies, and the risk of shocks to the domestic economy occasioned by exchange-rate changes); and asset-price volatility (e.g., excessively volatile stock and real-estate markets). The extra volatility of the current system also leads people to renegotiate contracts more frequently; to make contracts more complex; to shorten contract maturity; to try to avoid, *ceteris paribus*, longer-term commitments; and to alter their financial and investment strategies to guard against uncertainty. These responses increase negotiation and transaction costs, make it more difficult to plan for the longer term, and preclude otherwise worthwhile investment opportunities. Excessive volatility also disrupts cash flows and undermines liquidity—making planning more difficult, counterparties more likely to default, longer-term finance harder to obtain; and overall, rendering everyone less secure about their financial futures.

Inflation-induced uncertainty undermines "real" productive activity in other ways as well. As Peter Howitt (1990, 93–94) has observed,

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> It is no accident that finance was among the sectors with the most noticeable innovations during the 1970s and 1980s. The need to protect against inflation uncertainty, and the opportunity to take advantage of others' inability to do so, diverted a lot of innovative thinking away from creating new goods and processes and into the invention of new financial contracts, new banking techniques, and new corporate financial strategies. Young people on Wall Street were paid huge salaries, but the cost of those salaries was paid by the rest of us, who were deprived of the medical services, scientific research, and so on that the financial whiz kids could have been producing.

Critics of financial markets therefore have a good case when they argue that productive resources are being wasted on these activities. But they are mistaken when they attribute this problem to the operation of financial markets as such, rather than to governmental and central-bank policies that create unnecessary uncertainty. Private-sector parties justifiably feel obliged to spend resources to deal with this uncertainty; we should focus on why they feel obliged to react this way rather than criticize them for doing so. Of course, there will always be *some* volatility in financial markets, but one cannot conclude that all or even most of the risks and associated problems we observe in the contemporary world economy are the products of a laissez-faire regime—since such a regime does not currently exist. The real problem is too much state involvement in finance, not (as the critics maintain) too little.

Globalization and Instability

Fortunately, increases in capital mobility, lower transaction costs, improving information technology, and further developments in financial markets themselves—most notably, continuing developments in derivatives markets—will make it increasingly difficult for central banks to maintain policies that participants in markets perceive as indefensible.[8] These developments will therefore significantly reduce central banks' policy options. Markets now have little difficulty undermining crawling-peg exchange-rate policies, because these involve predictable exchange-rate changes that speculators can anticipate and so place bets on. Similarly, target-zone policies will become increasingly hard to maintain, particularly when markets perceive monetary policy makers as lacking the will or the resources to make the politically difficult decisions sometimes needed to keep exchange rates within target ranges.

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The same applies to "fixed" exchange-rate regimes,[9] even though they are usually perceived as involving a stronger and more credible exchange-rate commitment. For even fixed-rate regimes are dependent on long-run policy credibility, which is inevitably limited by the political context within which policy makers operate. Consequently, these regimes are also likely to be destroyed by speculative attacks once their credibility is undermined.

These factors are likely to drive central banks away from the middle ground between the extremes of zero intervention in foreign-exchange markets, on the one hand, and full currency union, on the other.[10] Each central bank will eventually need to decide whether to abstain entirely from intervention in foreign-exchange markets, or else tie itself ever more closely to one or more other currencies and eventually join a currency union. Faced with this choice, some of the more important central banks will probably choose the first option, and many of the smaller ones will probably choose the latter. The result will be the emergence of a small number of monetary unions, each based on some existing key currency, with relatively freely floating exchange rates between them.

Yet even this arrangement may only be an interim one. As the world economy becomes more integrated and remaining barriers between financial markets dissolve, the remaining currencies should become increasingly close substitutes for each other. However, currency substitution theory then suggests that exchange rates should become more and more volatile.[11] My guess is that the various governments and central banks involved will eventually feel obliged to intervene to counteract this increasing exchange-rate instability. However, exchange-rate intervention still raises the same old problems—crawling pegs are predictable, target zones are difficult to maintain over time, and so on—making this middle ground, too, unsustainable in the long run. Attempts to intervene in foreign-exchange markets to harmonize exchange rates are again doomed to eventual failure. But if monetary policy makers cannot live with freely floating exchange rates, their only logical alternative is to go to the other extreme, full monetary union.

And so we arrive at a fairly strong conclusion—the world monetary system appears to be headed for full monetary union—and the only question is how long it will take to get there. Monetary policy makers might resist it, and in the process create a great deal of exchange-rate volatility and associated problems for the private sector (and, of course,

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mountains of profits for speculators who bet against them), but the outcome itself appears to hard to resist.[12] Exchange-rate volatility should, therefore, *eventually* disappear. When it does, we might arrive at a financial system that is, in some respects at least, a reasonably close approximation to laissez faire.[13] But in the meantime, we will have to live with continued state intervention and the many problems it creates, and we should not misconstrue these problems as stemming from "unregulated" financial markets rather than from an overabundance of regulatory intervention.

NOTES

1. Soros is even more critical of free markets in his later (1998) book, *The Crisis of Global Capitalism*, the main argument of which is that "market forces, if they are given complete authority even in the purely economic and financial arenas, produce chaos and could ultimately lead to the downfall of the global capitalist system" (xxvii).
2. Any discussion of what a laissez-faire system might look like is inevitably speculative, and there is more than one version of such a system. The best-known of these is Hayek's vision of competition among floating fiat monies (Hayek 1976), but Hayek's proposal overlooks the likelihood that consumers would demand guarantees about both the convertibility of bank currency and the value of the unit of account, such that competition would force banks to provide such guarantees. In my view, a genuinely laissez-faire system would therefore tend to produce convertible currencies and a commodity "anchor" for their units of account.
3. Convertibility provides an assurance that bank currency will retain its value. It would tend to arise because consumers would want such assurance, setting in motion competition to provide it.
4. If consumers want price stability, as they evidently do, then competition (or the threat of it) should ensure that banks choose anchors that maximize price-level stability: banks that issue currency against anchors the public disliked would lose market share to banks that issued currency against anchors the public preferred. This competitive process would tend to converge on an anchor chosen to maximize the stability of a target price-index, and is discussed in more detail in Dowd 1996, 286–91.
5. For more on these, see, e.g., Leijonhufvud 1981, ch. 9 and Dowd 1996, ch. 16.
6. There are several reasons for such bias. One is that the seignorage revenue from inflation gives the central bank (and/or government) an incentive to inflate; another is that a government gains if inflation is higher than expected (e.g., Barro and Gordon 1983a and 1983b). The existence of this bias appears to be confirmed by the historical experience of the past 40 years: most coun-

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tries have experienced inflation most years, and there were few years in which prices anywhere actually fell.

7. See, e.g., Ball and Cecchetti 1990 and Evans 1991.
8. Indeed, financial markets already have considerable power over central banks and governments. Even the government of the United States is not immune. Thus, a contemporary remarked that

> President Clinton's friends complain that their tax and spend policies were frustrated by the "bond market vigilantes," who fear the federal government's multi-trillion dollar debt growing even more gargantuan. James Carville, the talented Clinton spin-doctor, remarked: "I used to think that if there was re-incarnation, I wanted to come back as the president or the Pope . . . but now I want to come back as the bond market. You can intimidate everybody." The fear of Wall Street's vigilantes is clearly a powerful constraint on Clinton's latent profligacy. . . . Clinton is reported to have raged against the constraints imposed by the bond markets on U.S. economic policy. (Staines 1996, 1)

9. Strictly speaking, so-called "fixed" exchange rate regimes are really only fixed-but-adjustable regimes, since central banks retain the power to make changes in exchange rates. It is the potential for exchange-rate adjustment that is the main problem here.
10. This argument is developed in much greater detail in Eichengreen 1984.
11. The claim that increasing currency substitution makes freely floating exchange rates more volatile is a well-known theoretical result in the currency substitution literature (see, e.g., Girton and Roper 1981).
12. There is nonetheless a qualification. A single currency is inevitable if the central bank(s) concerned stick with a fiat monetary regime, but if central banks restore commodity-based anchors, they should be able to prevent any further slide to a single world currency. We would then get a situation reminiscent of the laissez-faire arrangement in which there is some, but not much, volatility in exchange rates due to volatility in the relative price(s) of the anchors.
13. There is also the question of whether the underlying monetary regime will continue to be an anchorless fiat system. My own belief is that the fiat system is unsustainable in the longer term, and that some form of commodity-based anchor will eventually be restored. This will happen because the fiat monetary system will become unmanageable at some point. The problem is that a central bank's leverage over the monetary system—its ability to influence interest rates, exchange rates, and the money supply—hinges on the demand for central-bank "base" money, which is likely to fall very substantially, and perhaps even disappear outright. The declining demand for base money will cause major problems for central banks attempting to manage a fiat monetary system, but perhaps the most serious problem is that it will make prices and interest rates increasingly vulnerable to external shocks, especially changes in the technological and other factors that influence the demand for base

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money. A fiat system that ties the value of a currency to the demand for base money cannot be expected to deliver nominal-value stability in the face of major declines in the demand for base money, particularly if this demand disappears altogether. If these conjectures are correct, fiat monetary systems should produce increasing instability in nominal values, and central banks will find such systems more and more difficult to manage. The only way out would be to end fiat money altogether and tie currencies once again to some commodity anchor.

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Barry Eichengreen

THE CRISIS OF (CONFIDENCE IN) GLOBAL CAPITALISM

ABSTRACT: *In* The Crisis of Global Capitalism, *George Soros claims that the international financial economy is inherently unstable, and that while economists have failed to recognize this because of their commitment to static equilibrium theory, politicians have failed to stabilize the global economy because of their commitment to an unquestioned faith in the complete efficiency of laissez faire. While Soros is right to argue that market participants' expectations about the future can cause instability, he is wrong to maintain that this has gone unrecognized by economists, and his notion that we live in a world of economic laissez faire is equally mistaken. Indeed, his own analysis of the Asian financial crisis points to the "moral hazard" created by expectations of government intervention, rather than to laissez faire, as the culprit.*

In *The Crisis of Global Capitalism* (New York: PublicAffairs Press, 1998), George Soros—investment tycoon, philanthropist, and celebrity—lays out his life philosophy, delivers a stinging critique of modern economic theory, and comments on the health of the global financial system. He provides new information about his role and that of his investment partnerships, the Quantum Funds, in the Asian crisis in 1997 and Russia's default and devaluation in 1998. And somewhat surprisingly for our leading international financier, he offers some stunningly ambitious proposals for protecting civil society from financial globalization.

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Soros is a prominent public figure, and his opinions are taken seriously by the markets and by the congressional committees before which he is called to testify. It is therefore welcome to have his views in print.

Unfortunately, they come in a frustrating form. *The Crisis of Global Capitalism* shows signs of having been rushed into print in response to what the author perceived as the last gasp of an expiring global financial system. Divided into two parts, one of which lays out the author's conceptual framework and another of which applies it to the present moment in history, the book in fact wanders back and forth between conceptual and historical material. Repetition is a problem. Together with the book's informal tone, this leads one to suspect that portions are transcriptions of the author's conversations with his editor.

The book's fatal flaw, though, is that it is inadequately grounded in the scholarly literature. This is, to be sure, a predictable criticism coming from an academic called upon to review a practitioner's book. But pedantry aside, there is no question that Soros is led to commit some very serious blunders as a result of his ignorance, or at least disregard, of the relevant economic scholarship.

"Reflexivity" vs. Economic Equilibrium

At the core of the current approach to organizing economic activity, Soros argues, is a deep-seated belief that markets—financial markets in particular—are both stable and the best way of organizing economic and societal affairs. Soros attaches the label "market fundamentalism" to the belief in laissez faire of which he is so critical. He argues that financial markets, contrary to the rigid beliefs of the fundamentalists, are in fact unstable, and that important social needs cannot be met by giving them free reign.

Market fundamentalism, according to Soros, is grounded in notions of economic equilibrium. The basis for this argument is the author's theory of "reflexivity." In natural sciences such as physics, he observes, the concept of equilibrium is well defined. A swinging pendulum will eventually reach a stable resting point. This metaphor has been invoked by economists to describe the behavior of markets since at least Adam Smith, who argued that the self-interested actions of individuals will guide the economy to a stable, economically efficient outcome. Smith's notion was extended to the social domain by F. A. Hayek, who argued

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that the common social good was the unintended byproduct of individuals acting in their self-interest. The metaphor was formalized and refined, using the calculus, by the first postwar generation of welfare theorists, who took their cue from Paul Samuelson's *Foundations of Economic Analysis* (1947). The tools of the natural sciences and the professionalization of academia thus conspired to lend a veneer of respectability to the doctrine and the techniques of neoclassical economics—which are, in Soros's view, built fundamentally on an inappropriate notion of equilibrium.

Whatever damage this did to intellectual discourse, however, the damage to society (according to Soros) was far greater. Misguided equilibrium theorizing encouraged the United States (under Reagan), the United Kingdom (under Thatcher), and other countries to discard the regulated, mixed economy in favor of cut-throat capitalism. The result, Soros continues, has been to fray the social fabric, heighten the incidence of financial instability, and undermine political support for the market.

Why, according to the author, do models characterized by stable, socially efficient equilibria offer a misleading picture of the market system? The critical point, in his view, is that markets, unlike the systems analyzed by physicists, are inhabited by conscious agents; recognition of this fact leads Soros to his theory of "reflexivity." While "the facts about the natural world are independent of the statements that scientists make about them" (6), financial markets are influenced by what market participants think other participants are likely to do. Expectations affect actions, and actions affect expectations. Soros distinguishes the "passive function," in which participants seek merely to understand the situation in which they participate, from the "active function," in which they seek to make an impact on that situation. "Reflexivity" arises when both functions are at work.

The reflexive interaction of expectations and outcomes can give rise to indeterminacy, Soros observes, since what happens will in general depend on what people think is going to happen. And it can give rise to instability, as agents impulsively reject one belief about what will happen in favor of another. When markets move as expected, participants' confidence in their understanding of the underlying dynamic will be reinforced, sustaining the initial trend. But when expectations are consistently violated, they will have to be revised, and that revision may precipitate a violent change in market direction.

Market movements have such a powerful impact on expectations,

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Soros argues, because the world in which we live is complex. Not only is information about its structure incomplete, but our ability to assimilate the available data is bounded. Individuals make use of generalization, metaphor, and analogy (in other words, models) to impose order on this complexity. The stock they place in a model will be reinforced (or eroded) by the extent to which outcomes are consistent (or in conflict) with its predictions.

In financial markets, the beliefs and actions of market participants are profoundly conditioned by this "reflexive feedback." Imagine, for example, that investors are cautiously bullish about the stock market. If equity prices do rise, their bullishness will be reinforced, and they will adapt their behavior accordingly. As a result, prices may then rise at rates totally out of relation to any discernible change in market fundamentals. Analogously, pessimism about future asset prices can be reinforced by a decline in their current level, leading investors to sell into a falling market. Since economic predictions can be self-fulfilling, markets can be highly volatile.

Soros adds structure to these observations by dividing the boom-bust cycle into stages: an initial stage at which the trend is not yet recognized; a subsequent stage of trend acceleration; and a stage of excessive exuberance, when the trend is sustained by the reinforcement of initial expectations, despite the accumulation of counterevidence. Eventually there comes the moment of truth, when expectations are blatantly violated, and the trend reverses with a vengeance. In the worst-case scenario, an economic crisis ensues.

Social systems are prone to overshoot, Soros hypothesizes, in much the same way as markets. He observes that the Soviet system became increasingly rigid and authoritarian as a result of the two-way interaction of the dogma and practice of bureaucratic planning. Similarly, in the United States, financial deregulation has enhanced the political power of financial-market participants to press for still further deregulation, resulting in the creation of a dog-eat-dog "transactional society."

An open society is thus threatened from two directions. While authoritarianism was long the more worrisome danger, the collapse of communism has left nothing to resist market fundamentalism. Drawing on Karl Popper's book, *The Open Society and Its Enemies* (1945), Soros argues that unfettered markets dissolve social bonds and set the stage for an authoritarian backlash. They do not deliver the collective goods—the social justice, equity, cohesion, moral values, and support for strong

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families and intellectual achievement—that are the building blocks of an open society.

Popper's concept of the open society, in juxtaposition to authoritarianism, was already prominent in Soros's earlier book, *The Alchemy of Finance* (1987). What is new here is his opposition to market fundamentalism. Soros criticizes the Hayekian notion, popularized by works like Milton and Rose Friedman's *Capitalism and Freedom* (1982), that democracy and capitalism go hand in hand. To the contrary, he argues, unfettered capitalism will inevitably provoke a reaction against the depredations of the market. Clearly, Soros's views have been shaped by the failure of the market to reinforce viable democracy in the former Soviet Union. There, former enterprise managers, reinvented as capitalist robber barons, have been able to use political influence to take undue (some would say unfair) advantage of policies that were designed to create an unregulated market conomy. Those who found themselves excluded from the benefits of the market system and deprived of the social services to which they had been accustomed under communism responded by challenging the legitimacy of economic liberalization and democracy, placing the entire reform agenda at risk.

Unfortunately, Soros is vague when describing his middle way. An open society, he explains at one point, encourages critical modes of thinking "which explore the possibilities of change to the full." But he does not detail the specific institutional, political, social, and economic characteristics of societies that encourage such thought. An open society, he asserts, is characterized by a coherent set of values that prevent expectations and outcomes from reinforcing one another in destabilizing ways, which propels society away from the middle ground. Coherent values, by stabilizing expectations, anchor social arrangements. But how such values are constituted is never clearly specified. They arise, according to the author, out of the activities of a community of individuals, but how and why is not explained.

An Argument in a Scholarly Vacuum

Not all of these ideas will be unfamiliar to readers of this journal. Sociologists will recognize the resemblance of Soros's argument about the need to mitigate market outcomes to the theme of Karl Polanyi's influential tract, *The Great Transformation* (1944) (not cited by Soros). They will recall how, in response to the rise of totalitarianism in Germany

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and Russia, Polanyi suggested that sustaining political support for free markets may require the development of a mixed economy to temper market outcomes in socially acceptable ways. Economic historians will recognize the resemblance of Soros's boom-and-bust cycle to Charles Kindleberger's taxonomy of the stages of financial speculation in his classic *Manias, Panics and Crashes* (1978) (not cited by Soros). Political scientists will find Soros's discussion of communal values reminiscent of Robert Putnam's (1993) influential work on civic traditions (not cited by Soros). Soros's discussion of how market participants embrace a thesis and retain it until a critical mass of anomalous evidence forces them to reject it will remind historians of science of the concept of the "paradigm" as used by Thomas Kuhn in his widely read *Structure of Scientific Revolutions* (1970) (not cited by Soros).

And economists will be distressed by the portrayal of their discipline as beholden to the assumptions that individuals are hyperrational and that markets are characterized by stable equilibria. What may have been true of theorizing in Samuelson's or Alfred Marshall's day has not been true for many years. One might cite the work of such behavioral economists as David Laibson at Harvard and Matthew Rabin at Berkeley on issues like impulsivity, procrastination, and risk aversion. That Laibson and Rabin were both mentioned by *The Economist,* which takes it upon itself each decade to identify the ten most influential economists under the age of 35, hardly suggests that they are unimportant scholars. George Akerlof and Janet Yellen of Berkeley are famous for their models of "near rationality," which demonstrate that small departures from rational behavior can have profound macroeconomic repercussions. That Yellen was appointed by President Clinton to the Board of the Governors of the Federal Reserve System, and then chaired his Council of Economic Advisors, hardly suggests that she is out of the mainstream. Joseph Stiglitz of Stanford University made his name on the basis of models of asymmetric information (situations in which not all market participants are equally well informed), to which standard arguments about the interaction of supply and demand do not apply. That Stiglitz is a former chairman of the Council of Economic Advisors and was, until recently, the Chief Economist at the World Bank hardly suggests that the mainstream of the economics profession would dismiss him as a crank.

To be sure, the undergraduate's first economics course is disproportionately preoccupied by models with unique equilibria, in which the allocation delivered by a decentralized market maximizes profits, out-

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put, and social welfare. But the student then moves on to models of imperfect competition and asymmetric information in which outcomes are neither efficient nor unique. As soon as he encounters oligopoly and the theory of repeated games, for example, he is brought face to face with the uncomfortable fact that equilibria are indeterminate. Thus, Soros's critique of economic theory—that it assumes ergodic processes (in which markets quickly settle down to a uniquely determined, stable equilibrium)—reflects a misunderstanding of the field.

The Foibles of Finance

That Soros has failed to appreciate the influence of research on imperfect markets may reflect more than his failure to ingest scholarly articles written in the stilted language of economics journals. For many years, financial economics, the subdiscipline with which Soros is undoubtedly the most familiar, was slow to pursue the imperfect-market research agenda. Instead, specialists like Eugene Fama (1991) elaborated models of efficient markets in which the same financial asset could not be traded at different prices in different places, because such price discrepancies would offer irresistible arbitrage opportunities to traders and investors—whose self-interested, profit-motivated actions (buying assets where their prices were low and selling them where they were high) would work to eliminate the discrepancy automatically. Taken to their extreme, efficient-markets models suggested not simply that price discrepancies could not persist, but that they could not arise in the first place, since traders would act instantaneously to eliminate them.

Long-Term Capital Management (LTCM), the now-notorious hedge fund to which Soros points as an illustration of the mischief that can be caused by efficient-markets theory, in fact testifies to the kernel of truth underlying these models. LTCM was founded by efficient-markets theorists (two of whom received the Nobel Prize in Economics for their work) in order to apply these models to markets in U.S.-government securities. The explanation for LTCM's failure is nothing less than the power of the model: as the profits the fund made by arbitraging price discrepancies grew, other hedge funds, observing the success of LTCM, followed it into the field. The amount of money devoted to arbitrage activities exploded. As Alan Greenspan (1998, 2) put the point,

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> It is the nature of the competitive process driving financial innovation that such techniques would be emulated, making it ever more difficult to find market anomalies that provided shareholders with a high return. Indeed, the very efficiencies that LTCM and its competitors brought to the overall financial system gradually reduced the opportunities for above-normal profits.

As LTCM ran out of price discrepancies to arbitrage away, it branched into a variety of other, riskier investment activities about which its managers knew less. In the end, events those managers failed to anticipate—Russia's default and the subsequent "flight to quality" by international investors—brought its portfolio crashing down. In the ultimate irony, it was the efficiency of the market in pursuing the efficient-market model on which LTCM was based that eventually drove the fund into bankruptcy.

Moreover, the efficient-markets model is only one of several competing approaches to analyzing financial markets. There is now an extensive body of work that applies such concepts as asymmetric information and near rationality to financial economics. The National Bureau of Economic Research, situated squarely in the mainstream of the field, runs a program in Behavioral Finance directed by Robert Shiller of Yale and Richard Thaler of the University of Chicago. Among specialists in finance, it is understood that asymmetric information can give rise to herd behavior and sharp market moves. Such authors as Andrea Devanow and Ivo Welch (1996) provide formal models in which herding can arise even when all market participants are rational. They show that it can be in the self-interest of investors to emulate the investment decisions of other investors when there are information cascades (in which investors infer underlying conditions from the actions of other investors), when there are payoff externalities (in which the profits that accrue to one investor in, say, an Internet company depend on how many other investors purchase shares in the same company), or when there is an incentive to engage in mimicking behavior (for example, when investors are uncertain about the quality of mutual fund managers, giving inferior fund managers an incentive to mimic the behavior of other managers in order to avoid being found out).

It is these alternative models that inform the advice academic economists give policy makers in the supposedly "market fundamentalist" United States. Theoretical models emphasizing the pervasiveness of asymmetric information are used to justify public provision of a finan-

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cial safety net (in the form of deposit insurance and lender-of-last-resort services by the central bank) so as to prevent intrinsically fragile financial markets from seizing up. They justify prudential supervision of banks and other financial intermediaries, to prevent portfolio managers protected by the presence of that safety net from taking on excessive risk ("moral hazard"). That financial markets are fragile and volatile and that there is therefore a need to regulate banks, offer deposit insurance, and provide the services of a lender of last resort is conventional wisdom among economists. Only a small minority would contemplate abolishing federal deposit insurance or the Federal Reserve system—an indication of how deeply ingrained is the influence of the ideas whose existence Soros is at pains to deny.

It is similarly understood, not least within the corridors of the IMF, that information asymmetries are especially pervasive in the international markets that are Soros's special concern—where borrowers and lenders are separated to an exceptional extent by barriers of physical and cultural distance. These are the arguments that economists (and the IMF) invoke when urging caution on governments contemplating the liberalization of international financial transactions (see Eichengreen and Mussa 1998). For the vast majority of economists, Soros's conclusion that international markets may be particularly volatile will hardly come as a surprise.

The Man Who Broke the Bank of England

Some readers will suspect that these protestations are no more than an economist's parochial defense of his discipline. They should consider the scholarly literature on the 1992 crisis in the Exchange Rate Mechanism of the European Monetary System. This episode brought Soros to prominence: he is said to have made more than $1 billion in a matter of days by betting against the pound sterling, earning him the sobriquet "the man who broke the Bank of England."

The literature on this incident, admittedly, is not monolithic. A first generation of currency-crisis theorists, inspired by Paul Krugman (1979), modelled such events using the type of complete-information, efficient-markets assumptions of which Soros is so critical. Scholars who made use of these models characterized the 1992 sterling crisis as the inevitable collapse of an overvalued currency. Krugman's approach suggests that Britain's inflation must have been too high, its interna-

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tional competitiveness too low, for the ERM parity to be sustained. Eventually, balance-of-payments deficits would have depleted the Bank of England's foreign-currency reserves, stripping it of all capacity to support the currency and forcing sterling to be devalued. In speculating against the Bank of England, Soros was merely anticipating the inevitable, accelerating the currency market's convergence to its stable equilibrium.

However, a second generation of very different currency-crisis models has portrayed these events in a different light. Building on work by Robert Flood and Peter Garber (1984) and Maurice Obstfeld (1986), these models are characterized by equilibria that are neither unique nor stable. They suggest that currency traders like Soros were not simply anticipating the inevitable, but that they precipitated a change in the exchange rate that would not have occurred in the absence of the traders themselves. The story goes like this. The Bank of England had both an exchange-rate problem and an unemployment problem in 1992. On the one hand, it could keep interest rates high to support the exchange rate and build the credibility of its commitment to currency and price stability. But high interest rates would depress investment and do nothing to reduce the level of unemployment. Notwithstanding the political discomfort, however, British monetary officials were prepared to maintain the status quo in the absence of an attack on the currency. That is to say that they viewed the enhanced policy credibility they enjoyed because of the stabilized currency as justifying the costs associated with the persistence of unemployment. At this point, however, currency speculators who thought that this policy was politically unsustainable sold the pound en masse. Defending it now required the Bank of England to raise interest rates to still higher levels, doing additional damage to investment and further aggravating unemployment. Suddenly, the benefits of the additional policy credibility no longer dominated the political costs. A policy that the Bank of England and the British government would have been happy to pursue indefinitely in the absence of adverse speculation was now abandoned in response to speculative pressure. This is an apt characterization of how the Bank of England reacted in September 1992, when it briefly raised interest rates to 15 per cent in response to the Soros-led attack before concluding that the costs to the economy were too high, abandoning its defense of sterling and cutting rates to lower levels than before.

This is a model of unstable, self-fulfilling processes and multiple equilibria. One equilibrium obtains if Soros speculates against the currency,

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another if he does not; and in both cases his behavior, and that of the Bank of England, is perfectly rational. It is fair to say that this is now the dominant academic approach to analyzing currency crises. It is how leading economists analyzed the crises in Mexico in 1994 (Radelet and Sachs 1998) and Asia in 1997 (Krugman 1999). Soros's critique of the economics literature misreads or ignores scholarly work on the very episodes in which he himself has been most directly involved.

The further irony is that what makes these models run is precisely the two-way interaction of markets and policy makers. For instance, the Bank of England altered its stance in reaction to the actions of currency traders, and currency traders acted in anticipation of the Bank of England's reaction. The name for this in the academic literature may not be "reflexivity," but the phenomenon is the same.

Ideas and Economic Globalization

Soros ascribes great influence to ideas in altering the course of history, specifically to neoclassical economic theory in generating the process of economic and financial liberalization that swept the world in the 1980s and 1990s. Academics will be flattered by the notion that their scribbles have such power. But one suspects that academic theorizing has not been the sole or even the dominant factor behind the liberalization of markets, financial markets in particular. Technology too has played a role. The information revolution, in the form of computerized trading technologies (which permit immense amounts of money to be moved across borders at the stroke of a key, and which facilitate the efforts of financial rocket scientists to concoct derivative financial instruments) has made it enormously more costly for governments to stop capital flows at the border—just ask Malaysian Prime Minister Mahathir—leaving financial liberalization as the path of least resistance.

In addition, Soros's emphasis on the influence of doctrine minimizes the capacity of governments and societies (particularly those in industrializing countries) to learn from their experience. Having pursued autarchic policies of import substitution and financial repression and found them wanting, while at the same time observing the superior growth performance of East Asia's newly industrializing economies, Latin American governments drew the obvious conclusion. In other words, behind the shift to financial liberalization lay more than the rhetorical skills of the University of Chicago economists who took po-

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sitions in Latin American governments in the 1970s and 1980s. There is a reason they were appointed to those posts in the first place.

Nineteenth-Century Globalization

Now is not the first time that the world has seen global capitalism. Uncomfortably for Soros (and for other critics of the trend toward greater financial globalization), the late-nineteenth-century world of internationally integrated financial markets did not obviously display the same unstable tendencies as today. To his credit, Soros recognizes this paradox and addresses it, although the way he addresses it is severely flawed.

Soros lists three reasons why the nineteenth-century global economy was more stable than its late-twentieth-century successor. One is that the imperial powers, led by Britain, had a sufficiently large vested interest in the system to preserve it. Today, Soros points out, there is no comparable hegemonic power. In addition, a key component of the classical gold standard was the stability of exchange rates between the currencies at its center, which, Soros contends, prevented fluctuations there from causing dislocations at the periphery. The contrast with the yen-dollar exchange rate today could not be more pronounced. Above all, the nineteenth-century global economy was bound together by a universal system of shared beliefs and ethical standards (faith in reason, respect for science, and Judeo-Christian ethics). Again, Soros ascribes a powerful if mysterious role to ideology in the operation of the market system.

The economic historian confronted with Soros's account of the workings of the late-nineteenth-century international economy hardly knows where to start. For one thing, there is the fact that recent research on the pre-World War I international economy has falsified the "hegemonic stability view" (Keohane 1984) Soros accepts, according to which the dominant power, Great Britain, played a major role in stabilizing the system. The British economy was too small (only half the size of the United States circa 1913) to stabilize the world. In the international support operations that sustained the gold standard's key currencies between 1890 and 1913, the Bank of England was typically the supplicant, not the hegemon; the Old Lady was the borrower, not the lender, of last resort. And countries at the periphery of the international system repeatedly saw their exchange rates and balances of payments destabilized by sharp shifts in market conditions in the major market

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centers, particularly shifts in the London capital market's willingness to invest abroad (Fenoaltea 1988; Fishlow 1985). Finally, Britannia's attempts to maintain open markets were attributable more to self-interested lobbying by the export industries that dominated politics in the first industrial economy than to ideology or to any conscious effort to stabilize the international system. There is little evidence, whether in the archives of the Bank of England or in the record of parliamentary debates over tariffs and trade, that Britain tailored her policies with the stability of the global system in mind.

The Crisis in Emerging Markets

Soros cites the Asian crisis as a classic illustration of how a positive feedback loop can create unsustainable market conditions. In the early 1990s, he observes, international investors and bankers, impressed by the "East Asian Miracle," got it into their heads that the economies of the region were profitable places in which to invest. That prophecy was self-fulfilling: the more that money poured into Asia, the higher Asian stock markets climbed, fueling investors' enthusiasm for the region and disguising its underlying weaknesses. In the summer of 1997 a critical mass of anomalous information hit the market, in the form of Thailand's devaluation, which proved impossible to reconcile with the dominant model of financial stability and miracle growth. Thailand's crash thus prompted a wholesale revision of expectations, leading panicked investors to stampede out of the markets of not just Thailand but its neighbors and precipitating a full-blown economic and financial crisis.

This analysis bears more than a passing resemblance to Morris Goldstein's definitive account of the Asian crisis (Goldstein 1998). According to Goldstein's "wake-up call hypothesis," the Thai devaluation set off alarm bells, alerting international investors that conditions in the region were not entirely as advertised. More unexpectedly, Soros's account overlaps heavily with the official analysis of the International Monetary Fund (1998), the institution of which he is so critical elsewhere in his book.

In any case, Soros's account of the crisis begs as many questions as it answers. Markets are always prone to overshoot, if the theory of reflexivity is to be believed. Why, then, should the overshooting have been so marked in Asia, and why should the reversal and its consequences have

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been so severe? Why was the punishment so disproportionate to the crime?

To answer these questions, Soros is forced to appeal to factors outside his model. To account for the exceptional volume of funds that flowed into Asia, he points to the low level of interest rates in Japan and the United States (which rendered Asia's high yields attractive to international investors) and to the exchange-rate pegs operated by Asian governments (which gave international investors the false assurance that their returns were free of exchange-rate risk). The resulting "carry trade" ferried capital from Tokyo, where interest rates were low, to Bangkok, where they were high, undeterred by fears of a change in the yen-baht exchange rate. This narrative is the now-standard story of the Asian financial bubble, but it has nothing to do with reflexivity.

The standard view offers an explanation for why Thailand's devaluation and the depreciation of other currencies were so devastating to the economies involved. Asian banks and firms, and not only foreign investors, had been misled by their governments into believing that the region's pegged exchange rates would not change. They had no incentive therefore to use currency-forward and futures markets to purchase insurance against exchange-rate fluctuations, instead incurring large amounts of unhedged foreign-currency exposure. When the exchange rates did change, these complacent market participants were smashed; for instance, a large share of the Indonesian corporate sector, burdened by a heavy load of unhedged foreign debts, was thrust into bankruptcy by the sudden depreciation of the rupiah.

"Moral Hazard"

At first glance, Soros's narrative of events in Russia may seem more consistent with his portrayal of "global capitalism" in crisis than his account of the Asian meltdown. After 1989, he notes, international investors, irrationally exuberant about Russia's prospects and irresistibly attracted to the high yields of Russian treasury securities, poured money into the country. For a time, this tidal wave of liquidity papered over Russia's financial problems. But eventually, in the summer of 1998, it became impossible to deny that the country's budget and debt-servicing problems were insurmountable. Panicked investors rushed for the exits, bringing down Russia's financial markets and those of innocent emerging-market bystanders.

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This skeletal account omits a critical ingredient, as Soros subsequently acknowledges: What economists call moral hazard. Having earlier been shielded against losses from their holdings of Mexican treasury bills by the U.S.- and IMF-led rescue of that country, and then having been sheltered from losses on their short-term assets by the IMF's bailouts of the Asian crisis countries, international investors found high-yielding Russian securities irresistible precisely because they anticipated that the United States and the IMF regarded Russia as too big and too important to fail. (In the first half of 1998, international bankers regularly referred to Russian investments as "the moral-hazard play.") When investors discovered that the IMF was not in fact prepared to avert Russia's default, all bets were off.

Thus, while unregulated financial markets may be dangerously unstable, the way the international policy community has intervened, administering ever-larger IMF bailouts, has only compounded the problem by encouraging unwise risk-taking—moral hazard—through previous bailouts. IMF intervention may have averted a meltdown in Mexico; but, as Soros observes, by giving investors confidence that the Fund would again rush to the scene of future difficulties, the Mexican bailout encouraged them to pour money recklessly into Asia, Eastern Europe, and Latin America, setting the stage for even uglier future crises. With the collapse of these markets in the second half of 1998, the chickens came home to roost.

The critique of moral hazard is commonplace among economists, especially "market fundamentalists." Strangely, however, Soros's proposed departure from laissez faire, an International Credit Insurance Corporation to insure investors against debt defaults, would be subject to the same political pressures that led to crisis bailouts and moral hazard in the first place—that is, if we apply the same standard of realism to politics that Soros wants to apply to economics. Soros would somehow prohibit IMF aid to countries in financial trouble, while his proposed ICIC would assess fees on the bonds of solvent countries. But to assert that the international community will be able to stand aside in the event of default on uninsured loans, in disregard of the systemic consequences, is simply to assume a solution to the problem.

It is difficult to avoid the conclusion that Soros is in the grip of an *idée fixe*, "reflexivity," which he wants to use to explain too much. If financial crises can be attributed mainly to reflexivity, if economists have ignored this problem, and if governments have been prevented from solving it by laissez-faire doctrine, then the way to ensure the safety of

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the global economy is to put the idea of reflexivity—to which Soros attributes his own financial success—on the agenda of economists and politicians and to campaign against free-market dogmatism.

But "market fundamentalism" is a myth. Economists have not ignored the problem of reflexivity. Politicians are already deeply involved in the international economy. A full understanding of the recent financial crises and their implications for the future cannot be obtained from an analysis that, like Soros's, ignores these facts.

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George Soros

REPLY TO EICHENGREEN

Barry Eichengreen is justified in criticizing me for ignoring the recent literature in economic theory and for failing to identify the thinkers whose writings have influenced me.

I only wish, however, that he were right in minimizing the influence of market fundamentalism. Our congressmen seem to be even less familiar with the recent economic literature than I am. The International Financial Institutions Advisory Commission mandated by Congress has recommended a drastic downsizing of international financial institutions. The Commission recommends that the International Monetary Fund be converted into a quasi-lender of last resort, but only to *those countries that open up their financial systems to foreign competition*. The underlying argument is that the international provision of capital should be left to the markets. I see very little recognition here that international financial markets are inherently unstable. The emphasis is on eliminating the moral hazard created by IMF bailouts.

In my view, the invocation of moral hazard is a product of market fundamentalism. It means that there should be no interference with market discipline. But if markets are unstable, imposing market discipline means imposing instability, and how much instability can emerging market economies put up with? I propose replacing "End moral hazard" with another slogan: "Create a more level playing field." That is what my various proposals seek to accomplish.

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I acknowledge that second-generation financial-crisis models deal with reflexive phenomena, but I consider Eichengreen's expression "multiple equilibria" a misnomer; "dynamic disequilibrium" would be more appropriate. Congressmen might sit up and pay attention to such terminology.

Contrary to what Eichengreen says, I do not wish to use the theory of reflexivity to explain too much; I use it to explain why financial markets and historical processes in general are genuinely indeterminate and why explanations of them cannot meet the criteria imposed by equilibrium theory.

He is right, however, in implying that I overused my boom/bust model. I found his critique helpful. I hope to have made my position clearer in my new book *Open Society: Reforming Global Capitalism*.

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Tyler Cowen

RISK AND BUSINESS CYCLES: REPLY TO ROSSER

ABSTRACT: *Rosser's thoughtful and careful review of my book on business cycles reflects a different methodological stance than my own. I believe that economic theory and macroeconomics cannot escape using the concept of risk, even though, as Rosser points out, risk is not a simple unidimensional magnitude in many circumstances. I view the rational expectations assumption as a useful way of presenting a theory, rather than as a descriptive account of real-world expectations.*

My book *Risk and Business Cycles* attempts to synthesize the best from earlier Austrian-school business-cycle theories and modern macroeconomics. Working within a framework of rational expectations, I attempted to explain how business cycle might arise.

I outlined two central scenarios. First, an increase in monetary volatility will decrease the profitability of investment projects and move the economy to lower-yielding projects, leading to an immediate downturn. Second, gentle inflations will induce more investment in higher-yielding but risky projects. There will be a short-term boom, but in the long run the economy will be riskier and the likelihood of a cycle will go up. Sometimes, however, the new investments will pay off and no downturn will arrive. I examined how each of these scenarios fare against both econometric evidence and the stylized facts.

The two scenarios differ from traditional Austrian-school theory, as

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outlined in the writings of Mises, Hayek, and Rothbard, among others. Such writers focus on inflation *per se*, rather than on monetary volatility. In their account, inflation and artificially low real interest rates fool investors into excessively long-term projects, which then necessarily fail, causing an economic downturn.

I criticize the Austrian account for its overly particular structure and for failing to explain the data. Most plausible expectational errors will lead to scenarios different than the one the Austrians have outlined. And the Austrian theory does not explain a number of well-known stylized facts, such as the comovement of consumption and investment (the Austrian theory predicts that they should move in opposite directions), or the rise in real wages during a boom.

I would like to thank J. Barkley Rosser for his very careful and sympathetic reading of my book in *Critical Review* 13, nos. 3–4. I would like, however, to respond to some of his criticisms and indicate how and why I see things differently. As I read Rosser, he has four criticisms of the book, two methodological and two particular:

1. He believes the assumption of rational expectations is unwarranted.

2. He is unhappy with the standard concept of risk, as used in the book.

3. He is not convinced that interest-rate declines will make the economy riskier.

4. He argues that inflation will not lower real interest rates in a world of rational expectations.

I will consider each of Rosser's criticisms in turn.

Rational Expectations

As my theory is outlined, business cycles arise through changes in the level of economy-wide risk. By using the concept of risk in this fashion, it is possible to explain cycles without invoking systematic expectational errors. Both booms and busts result from increases in risk, which sometimes pay off and sometimes do not. The varying fortunes of dot-com firms are arguably an example of this phenomenon.

Rosser notes correctly that many original pioneers of the rational-expectations assumption, such as Thomas Sargent, are now moving away from it. He thus wonders why a neo-Austrian theory should make it its starting point.

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The model in my book does not present the rational-expectations assumption as descriptively true. But it is a useful assumption for the following reason. We wish to know which of the outcomes posited by an economic theory stem from expectational errors and which outcomes stem from other mechanisms. I therefore tried to examine how monetary mechanisms would operate in the absence of expectational errors. Using the rational-expectations assumption ensures that expectational errors would not be doing all the work of the theory.

No doubt a richer and fuller theory would then pile expectational errors on top of these basic mechanisms. But the fact remains that we do not know very much about how these expectational errors operate. Results from experimental economics are suggestive but far from conclusive. For that reason I decided to focus on the non-expectational mechanisms of the theory.

Traditional Austrian theory illustrates the problems with failing to specify rational expectations. The older Austrian theories never explicitly spell out their expectational assumptions, and for this reason these theories are hard to evaluate. My major criticism of these theories is not that investors are always rational (as Barkley suggests), but rather that plausible irrationalities will lead to scenarios different than the Austrians have outlined. I outline this charge in detail in chapter four of the book.

I also argue that many of the costs of inflation can be explained without jettisoning the rational-expectations assumption. Monetary variability remains undesirable, for instance, because it raises the costs of planning and makes the future harder to forecast. We do not need systematic expectational errors to present this idea.

Contrary to some Austrian accounts (though Barkley does not make this mistake), the rational-expectations assumption does not require that individuals are superhuman calculating machines. It rather postulates that human beings make many different kinds of errors, rather than making the same kind of error over and over again (see Cowen 1997, 8–9). We can think of rational expectations as implying that errors are equally likely in all directions. Again, while I do not view this postulate as descriptively true, I think it is a useful starting point for business-cycle theory. Some of today's neoclassical economists are indeed moving away from the rational-expectations assumption, but they still would emphasize its usefulness as a starting point in the initial specification of a theory.

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Risk vs. Uncertainty

The argument of my book assumes that some investments are riskier than others. Moving to a larger scale, some macro conglomerates of investment—structures of production, in Austrian terminology—are riskier than others as well. Unless these comparisons have some meaning, it cannot be said that variable inflation makes investments riskier, or that lower real interest rates induce more investment in risky projects.

Rosser (377) notes: "If there is a fundamental criticism that an Old Austrian can make against Cowen, it may be that he has fallen into a widely believed error regarding the nature of risk . . . The Old Austrians and Keynes share, along with Chicago's Frank Knight, a fundamental appreciation for the role of unquantifiable uncertainty."

I grant Rosser's point that we do not have a very good theory of risk. This has been well known in finance for some time. The most common univariate measure of risk is Beta, or the covariance of an asset's return with a broader market portfolio of assets. Some finance theorists have developed arbitrage pricing theory, which involves multivariate measures of risk, with varying success. Barkley, as I read him, seems to think that most economic forms of risk are not quantifiable at all.

We cannot escape believing that the concept of risk means something. Virtually all of us would argue, for instance, that an arbitrary regulatory state makes investment riskier and thus imposes economic costs. A large-scale war makes investment riskier as well. Claims of this kind can be found even in the writings of Mises and other Austrians, although not always using the risk terminology. Nor did Keynes hesitate to talk about lesser and greater risk, despite his clear understanding of what Barkley calls Knightian uncertainty. I am unhappy that we do not have a single fully satisfactory measure of risk, but we should not conclude that claims about risk are meaningless.

Consistent with the above reasoning, I believe that highly variable inflation makes an economy, and particular economic investments, riskier. I also believe that highly ambitious long-term investments are typically riskier than holding T-bills. I use the concept of risk in my work to formalize these intuitions and put them into some kind of workable form. I do not think that real-world risk can in fact always be boiled down to a single dimension. Still, all theories must make simplifying assumptions, and that is one of mine. The standard Austrian the-

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ory promulgated by Mises and Hayek also requires that the new investments are riskier (e.g., they have a high probability of a significant downside). They refrain from using the R-word (risk), but this is imprecision; it is not an improvement on the basic concept.

If the Austrian economists wish, we could instead talk about "more" or "less" Knightian uncertainty. For the modern American Austrians, virtually all economic transactions bring unquantifiable Knightian uncertainty rather than "risk," at least outside the gambling casino. But there remains a meaningful difference between the uncertainty of ordering pizza in a new restaurant, and the uncertainty of storming a drug dealer's hideout with machine guns.

Do New Investments Bring More Risk?

Risk and Business Cycles argues that new investments, as induced by real interest rate declines, typically make the economy riskier. Rosser (381–82), in his most particular criticism of my theory, challenges this presumption. He questions whether the new investments will be riskier than the old.

Here Rosser has misunderstood the basic mechanism I posit. My claim is not that the new investments will be riskier than the old ones (which may or may not be true). I claim instead that the new investments are riskier than devoting those resources to immediate consumption would be (see, for instance, Cowen 1997, 18–19). So overall risk increases, even if the 27th investment that is made is less risky than the 26th investment.

Do Monetary Changes Lower Real Interest Rates in a Rational-Expectations World?

Rosser (385) argues that "the claim that expansionary monetary policy will lower the real rate of interest (cf. Butos 1993) sits uneasily with the perfect foresight posited by Cowen's rational-expectations extremism, which would imply no change in real interest rates, as people perfectly anticipate inflation attendant upon monetary expansion. . . ."

In contrast, increases in the supply of loanable funds will lower real rates of interest with or without rational expectations. The effect is one of simple supply and demand. If there are more funds to be lent out,

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the real interest rate falls to clear the market. I discuss these issues at length on pages 64–74 of my book, also citing a variety of rational-expectations models with real-interest-rate effects.

In closing, I would like to make a final plea that my work does in fact merit the title "New Austrian." I see at least two notions of "Austrian" economics in the marketplace of ideas. The first refers to the "New York School" that grew up around Mises, Rothbard, and Kirzner. The second notion of Austrian economics, more widely used among economists, also would include Friedrich von Wieser, Joseph Schumpeter, some of John Hicks's work, Oskar Morgenstern, some of Fritz Machlup and Gottfried Haberler, and the "neo-Austrian" capital theory writings of Continental economists. This second usage of *Austrian* is more catholic than the first, and is what I intended when I titled my book.

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J. Barkley Rosser, Jr.

RISK AND AUSTRIAN BUSINESS-CYCLE THEORY: REJOINDER TO COWEN

ABSTRACT: *Cowen and I agree that rational-expectations theory is unrealistic and that risk is difficult to quantify. However, we continue to disagree about the riskiness of consumption as opposed to investment. Since more investment might lead to a recession if investment is relatively risky, Cowen's use of rational-expectations theory to buttress the Austrian school's claim that market economies can shift toward relatively more investment without experiencing macroeconomic disruption remains suspect.*

I welcome Tyler Cowen's thoughtful response to my remarks on his *Risk and Business Cycles*, which lays out a New Austrian view of business cycles based on risk analysis within a rational-expectations framework. I appreciate his ability to overlook some of my harsher remarks and to appreciate my sympathy for certain of his efforts. I seek here to clarify our areas of agreement and disagreement in light of his Reply. I shall focus on the four areas of apparent disagreement that he identifies.

The first involves the concept of rational expectations. I welcome Cowen's acknowledgement that he is open to the possibility that rational expectations may not be descriptively true. I agree that it can nevertheless be useful to contemplate the implications of models that assume rational expectations. As I said in my original essay (Rosser 1999), Cowen pinpoints awkward problems regarding assumptions about expectations in the Old Austrian business-cycle theory.

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However, it would have been useful if Cowen had made it clearer in his book that he does not necessarily believe that people actually have rational expectations. There has been altogether too much macroeconomic literature in which rational expectations are assumed to hold both in theory and reality. Cowen's apparent dismissal of the Old Austrians because of their violation of this assumption made it easy to believe that this was Cowen's view also.

As Cowen notes, the recent experimental evidence has not been friendly to the assumption of rational expectations, quite aside from the kinds of complexity arguments that I raised. How strained the rational-expectations assumption has become can be seen by some recent defenses of it. Thus, it has been argued that people in the United States have rational expectations because they consistently underpredicted the rate of inflation during the 1970s and then consistently overpredicted it during the 1980s, thus averaging out to having predicted it correctly with the errors balancing out. This may technically conform to the definition. But it certainly violates the spirit of "random errors" when one sees many years in a row of consistent errors in the same direction, as appears to have happened.

I appreciate that Cowen understands that if risk is to be properly quantified, it may need to be done in a multidimensional manner. Again, it would have been useful if this had been recognized explicitly in the book, given the centrality of risk to the analysis. Although Cowen detects in my remarks a "hard line," which would allow only nonquantifiable uncertainty, my view accepts a spectrum of approaches, depending on the circumstances of the analysis.

Thus, with regard to the effects of monetary variability, one might observe a monetary policy that reduces the variance of fluctuations but increases the leptokurtosis (fatness of tails) of the fluctuations. The extreme version of this type of policy would have been Soviet socialism, which eliminated short-term business cycles but eventually experienced total collapse. A milder version might arise from an apparently successful discretionary policy that smooths out short-term fluctuations but leads to a larger occasional fluctuation. In any case, it is clear that Cowen and I agree that we do not yet have a fully adequate theory of risk.

As regards the issue of new investments bringing greater risk, Cowen is right that we have a sharp disagreement. He suggests that I did not understand the difference between his argument that consumption is safer than investment and the argument that the 27th investment is

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riskier than the 26th investment, *ceteris paribus*. I understood his point but disagreed with it. If consumption is so safe, why do people who perceive the future to have become somehow riskier tend to save more and consume less, as for example when they come to fear possible job loss? Cowen might argue that what is individually safer is riskier at the macroeconomic level because of fallacy-of-composition (or "paradox-of-thrift") effects. But he has not done so, to my knowledge.

With respect to the issue of rational expectations and real interest rates, I grant that there are reasonably consistent models of loanable funds in which rational expectations hold and increases in loanable funds can reduce real interest rates.

Finally, let me note some new confusion regarding terminology that creeps into the end of Cowen's reply. Cowen justifies his use of the term "New Austrian" by linking it to a presumably "more catholic" version of "neo-Austrian capital theory." I think it would be better to let "neo-Austrian" refer to modern Austrian economists who are not from Austria, a usage I have already seen implemented, and to let "New Austrian" refer more specifically to an approach based on the rational-expectations assumption. After all, it is rational expectations that distinguishes "New Classical" from "Old Classical" economics, with both drawing from the more general "neoclassical" school. Likewise, "New Keynesians" assume rational expectations in contrast with "Old Keynesians" and "neo-Keynesians," each of which represent distinctive viewpoints. I believe that Cowen should take credit for his "New Austrian" neologism and not muddy the waters by attempting to confound it with the already existing and distinct "neo-Austrian."

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Ilya Somin

DEMOCRACY AND VOTER IGNORANCE REVISITED: REJOINDER TO CIEPLEY

ABSTRACT: *Democratic control of public policy is nearly impossible in the presence of extreme voter ignorance, and this ignorance is in part caused by the vast size and scope of modern government. Only a government limited in its scope can be meaningfully democratic. David Ciepley's response to my article does not seriously challenge this conclusion, and his attempts to show that limited government is inherently undemocratic fail. Ciepley's alternative vision of a "democracy" that does not require informed voters turns out to be not a defense of democracy at all, but a rationalization for any form of government that achieves a high level of leadership skill and bureaucratic efficiency.*

I would like to thank David Ciepley for his interesting Reply (in *Critical Review* 13, nos. 1–2) to my article "Voter Ignorance and the Democratic Ideal." While my Rejoinder necessarily focuses on our disagreements, it is important as well to note the broad areas of consensus between us. Ciepley does not deny—indeed, apparently endorses (204)—the two central points of my argument: that democratic government, in the sense of voter control of public-policy outcomes, requires at least a modicum of substantive knowledge on the part of voters; and that the size and scope of modern government make it virtually impossible for voters to acquire the necessary

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amount of information across the full range of issues controlled by the state.

The second half of Ciepley's article is devoted to a defense of a different conception of democracy, in which the key element is not voter control of public policy, but the selection of capable leaders. Although, as briefly discussed below, I have reservations about Ciepley's version of democracy, I certainly do not deny that a "democratic" political system in which voters lack control over public policy may be superior to authoritarian alternatives. As I noted in my article, popular control is not the only, perhaps not even the most important, value we must take into account when comparing the merits of alternative political institutions (Somin 1998, 445).

Ciepley confronts my arguments more directly in the first part of his essay, where he attacks my suggestion that government could be made more democratic, in my sense of the term, by limiting its scope. He claims that limited government, at least in a democracy, is inherently impossible; at the very least, it would be undemocratic (193–99). He argues further that the sorts of information problems I detect in the political sphere would also infect decision making in private markets handling the same matters (199–204). While I did not directly address these complex issues in my initial paper,[1] I will briefly discuss them here. It is important to note, however, that my remarks are not intended to resolve the question of the feasibility of limited government or the seriousness of information problems in the private sector comprehensively; my sole purpose is to consider Ciepley's particular arguments.

Ciepley's most radical claim is his suggestion that limited government is not only undesirable, but inherently impossible. He claims that in a democracy, the electorate can always circumvent any limits of which it disapproves strongly enough, and that even constitutional restraints on government power are effective only when they are believed to express the will of "We the People" (193–99). And he is dismissive of the idea that government power can be constrained by unelected institutions such as courts (196–97).

While theoretically interesting, Ciepley's argument flies in the face of extensive empirical evidence that strictly limited government, especially at the federal level, did exist in the United States and elsewhere until at least the 1930s (e.g., Higgs 1987; North 1981; Anderson and Hill 1980; Weingast 1993 and 1995), and that courts played an important role in maintaining such constraints (Siegan 1980). Indeed,

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economic historians claim that the development of institutionalized constraints on government power was the key factor in the rise of the Western nations to economic and political preeminence in the world (North and Thomas 1973; Rosenberg and Birdzell 1986).

Even today, constitutional limits imposed by American courts lead to much stronger constraints on government power in areas such as freedom of speech and religion, federalism, and the establishment of racial preferences than elected legislative bodies would accept if left to themselves. Nor are courts the only, or even the most important, mechanisms of restraint; federalism (Weingast 1995), ideological consensus in favor of limited government (North 1981; Higgs 1987; Tocqueville 1969 [1837], 164–65, 262–63; Bryce 1895, vol. 2, 369, 536–37), lack of bureaucratic capacity (Skowronek 1982), and separation of powers (e.g., Buchanan and Tullock 1962; Weingast 1993) all served as additional sources of constraint in the last century, and to a lesser degree do so even today.

In a partial attempt to counter this evidence, Ciepley points out that nineteenth-century American state governments were more active than the federal government (194), and he also notes the famous defeat of the Supreme Court's efforts to limit federal power during the New Deal era (196). Yet while state governments were indeed somewhat more active than the federal government in the nineteenth century, Ciepley is wrong to claim that they were not still tightly constrained. As late as 1929, state-government spending constituted only 7.5 percent of GNP, compared to almost twice as much today (ACIR 1994, 27, Table 9; ACIR 1988, 4, Table 2). Likewise, state-government employment per capita in 1929 was only one-fourth of 1990s levels,[2] and was much lower still in the nineteenth century (ACIR 1994, 11, Table E).[3] State-government activism was sharply curtailed by nineteenth-century courts, especially after the Civil War (Siegan 1980; Freund 1904), and, even more significantly, by interjurisdictional competition (Weingast 1995).

While it is true that the Supreme Court was defeated in the confrontation over the New Deal, it was victorious in numerous other efforts to limit the powers of other branches of government (e.g., Siegan 1980). Even the New Deal was not an unambiguous defeat; the Supreme Court's 1935 invalidation of the National Industrial Recovery Act, a centerpiece of New Deal legislation, was never reversed (and remains binding precedent), despite repeated efforts by the Roosevelt Administration to circumvent it (Leuchtenberg 1963, 145–46).

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Ciepley argues more broadly that even where seemingly effective limitations on government power do exist, in a democracy they rest ultimately on popular acquiescence (195–96). Thus, for example, the electorate can overturn a constitutional limitation on federal power by means of a constitutional amendment (196). While this is true as a matter of abstract political theory, there is an enormous difference between restraints on government power that can be overturned by ordinary legislation and those that can be reversed only by cumbersome supermajority mechanisms, such as constitutional amendments. Even on the level of theory, such mechanisms substantially constrain democracy (defined as majority rule), in that they enable a minority—in the case of constitutional amendments, a very small minority (one-fourth of all U.S. state legislatures, irrespective of the size of the states' populations)—to block an expansion of government power favored by an overwhelming majority.

Obviously, restrictions such as the constitutional amendment procedure can, in theory, be circumvented by a highly determined popular majority—for instance, through the threat of violent revolution. But in practice, collective-action problems and an assortment of institutional constraints render such extraordinary upheavals rare, even in cases where the majority of the public is genuinely dissatisfied with existing political institutions (Kuran 1995, Olson 1965). Ciepley may be right in the narrow sense that no constraint on government power can be 100-percent foolproof; he is wrong, however, to believe that such constraints cannot be highly effective, even in the face of popular opposition.

Ciepley also contends that constraints on government power, even if feasible, would be undemocratic (195–99). After all, he reasons, someone would have to make the decision to take certain issues off the government's agenda (195–96). If such decisions were left up to the electorate and its chosen representatives, then there would be no real limitation on government power, since the legislature could simply breach self-imposed limitations whenever it wished to do so. But if elected officials were denied that power, the resulting government would be undemocratic in nature, since the scope of the public agenda would be defined without the participation of voters (196).

This argument misinterprets the point I was attempting to make. I was not claiming that the limitation of government power would enable all social decisions to be made democratically, but that it would enable—more accurately, increase the likelihood of—democratic

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control of such decisions as were made by government. The price of true democratic control over *any* issues is to renounce the modern impulse to subject *all* issues to such control. If my argument concerning the relationship between voter knowledge and the scope of government is correct (and Ciepley does not dispute it), then that impulse is chimerical.[4] We do not have the option of imposing democratic control on all aspects of society, even assuming such an outcome to be desirable. Our only real choices are to impose it on some issues by explicitly abjuring it with respect to others, or to give up the hope of democratic control almost entirely.

The notion that constraints on the power of democratically elected officials may sometimes reinforce democracy rather than undermining it is not a new one in political theory, and has been advanced by a variety of scholars across the political spectrum (e.g., Holmes 1988, Hayek 1960, Ely 1980). It is based on the simple idea that constraining democracy with respect to some matters may reinforce it with respect to others. My particular contribution is to apply this maximizing conception of democracy to the question of voter ignorance.

To say that limited government is both feasible and (potentially) democratic is not, of course, to claim that a much more constrained government than we have today can be achieved in the near future. It does not even entail the claim that such a government is desirable, since, as I have noted, democratic control is not the only issue that must be considered in making a normative decision of this type (Somin 1998, 445). All that I have tried to do here is call into question Ciepley's arguments that limited government is inherently impossible, almost by definition; and that, if feasible, limited government would necessarily be undemocratic.

Ciepley next argues that I ignore the fact that information problems also arise in the private sector. He suggests that the real problem is not political control of decision making but the "complexity" of society, which renders many important matters too complicated for ordinary people to understand (198–99).[5] In his view, it is not political control but the difficulty of the question at hand that determines whether the public will be able to understand it or not.

That information problems exist in the private sector no one will deny. However, Ciepley's argument fails to take account of the unique properties of the public sector, which render such problems much more severe there. Here, I consider only the two most important of these properties.

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First and foremost, as I explained in my article, private-sector consumers have much more incentive than voters to acquire information about the quality of the goods they are "buying" (Somin 1998, 435–38). A single vote, no matter how well informed, has virtually no chance of affecting the outcome of an election, and thus no chance of achieving whatever goals the voter believes may be served by electing his preferred candidate. Voters are therefore "rationally ignorant" of public policy (Downs 1957, ch. 13). By contrast, a private consumer is in sole control of his consumption decisions,[6] and thus has every incentive to invest in obtaining the necessary information to make a good choice. As far back as Walter Lippmann (1922) and Joseph Schumpeter (1950), scholars have noted that most members of the public invest far more time and effort in gathering information about private consumption decisions than in attempting to become informed voters, a task to which most devote almost no time at all (Neumann 1986).[7] Everyday life experience seems to confirm this insight; even political junkies devote far more time to deciding which apartment to rent or which car to buy than whom to vote for.

Thus, citizen demand for information regarding private-sector-produced goods is likely to be stronger than that for political information. There is also a major difference on the supply side. The public sector has no efficient means of conveying information in an easily understood fashion that is comparable to the market's price system. Thus, a person who wishes to purchase a product or service can learn a great deal about its utility simply from its price, even apart from all other information. The market price, in effect, represents the accumulated knowledge of all other consumers—including those who chose not to buy the good, thus lowering its price (Hayek 1945). Ciepley seems to miss the point of this argument when he responds to it by claiming that it does not apply in cases where the good to be purchased is complicated in nature (200–204). The reason for the price system is that it eliminates, or rather greatly reduces, the need for consumers to consider such complexities. They will be incorporated into the price by means of the prior consumption and production decisions of others, which the price reflects.

Ciepley is on firmer ground when he notes that information about some goods, such as national defense, cannot be readily conveyed by prices (11). The reason, however, is not that these goods are especially complex, but that they are "public goods" in the strict economic sense.[8] In the case of a public good, the consumption of which is

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nondivisible and nonrivalrous, individual consumers have no incentive to purchase it of their own accord, and thus the market price will likely understate the demand (Samuelson 1954). This is an argument for government provision of public goods, though not necessarily a decisive one.[9] In any event, however, the vast majority of the modern state's functions do not involve public goods in this sense. Most of what modern states do is a result of pressures exerted by "distributional coalitions" of interest groups in favor of the public provision of *private* goods (Fitts and Inman 1990, 80; Olson 1982).

For the two reasons I have advanced, market systems have historically been quite effective in conveying information about even very complicated goods, such as cars, houses, and education.[10] Despite Ciepley's conjecture that private-sector information sources on the quality of goods are likely to be "captured" by the goods' producers (203), there are in fact numerous such sources that remain independent, often providing information about the most complicated goods.[11] The record is, of course, very far from perfect, but it does point to the tentative conclusion that the informational problems Ciepley cites are less severe among consumers than among voters.

Finally, although it does not relate directly to my original article, I wish to comment briefly on Ciepley's "Weberian" rationale for democracy—a rationale that, he claims, holds true independently of voter control of public policy. Ciepley maintains that democracy can be justified even if voters have little or no leverage over policy outcomes, because it produces a superior class of political leaders and an efficient bureaucracy.

I would like to register two major reservations about this defense of democracy. First, it is not really a defense of democracy at all, but of *any* political system that might produce competent leaders and efficient bureaucrats. Ciepley provides no evidence, beyond a few conjectures derived from Weber, that a democratic state with leaders chosen by ignorant voters is likely to be run by bureaucrats and political leaders more efficient than those produced by other forms of government. But an empirical question of this sort cannot be settled by an appeal to authority, even as great an authority as Weber. And in fact, Ciepley's list of the characteristics of an ideal political leader—commitment, political judgment, a sense of responsibility, "dispassionate assessment of the situation" and of "rival ethical claims," and an ability to rise above popular pressures and maintain "distance from the people" (217–20)—sounds more like a description of a benevolent

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despot than of a democratic politician driven by the calculations of electoral politics. Ciepley emphasizes (214) that it is especially important that a prospective political leader be "selected in political struggle"—a criterion that surely favors dictators selected by means of intensive forms of competition, such as military coups, civil wars, and palace intrigues, rather than democratic leaders chosen in the much less rigorous "struggle" of elections.[12] Indeed, Ciepley acknowledges that the critical factor in selecting political leaders of the stamp he seeks is not the role of voters, but the "preselection" of candidates by political elites (223–24). If this is the case, it is not clear why—on Ciepley's conception—we should not dispense with elections entirely. After all, so long as elections continue to exist, the "preselectors" are likely to be influenced in their choice of candidates far more by the probability that their choice will prevail in a general election than by any assessment of character using Ciepley's benchmarks.

The possibility that Ciepley's argument is a justification of some form of despotism rather than democracy leads directly to my second criticism. Ciepley is led to this pass because, despite his emphasis on the "ethical" dimensions of politics (220), he seems to value skilled political leadership and efficient bureaucracy independently of the ends they serve. Yet, at the risk of belaboring the obvious, leadership skill and bureaucratic efficiency can just as easily serve bad ends as good ones. Adolf Hitler, for instance, must surely be numbered among the leaders who fit Ciepley's criteria. He had excellent political "judgment," including an insightful understanding of his supporters and opponents and their strengths and weaknesses (218); he had a strong sense of "responsibility" for the future of Germany and the world, and was exceedingly concerned with the judgment of "posterity" (219–20); he was deeply committed to his "cause"; and he always maintained a proper "distance" from the people—indeed, he sought to manipulate their impulses, as he boasted in *Mein Kampf*, rather than allowing himself to be guided by them (219).[13] Of course, Hitler was not perfect in these respects; his judgment failed him when he prosecuted a war against an overwhelmingly powerful opposing coalition. Yet his striking political successes in building, almost from scratch, a political movement that first seized control of Germany and then very nearly came to dominate the entire Western world, must give him high marks by Ciepley's criteria—certainly higher than that of the vast majority of democratically elected politicians.[14]

Similarly, the German officials and military officers who oversaw

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Hitler's rearmament program, led his armies, and organized the Holocaust match Ciepley's criteria for ideal bureaucrats: they displayed a high level of professional expertise, and most were not corrupt in the narrow sense of the word he employs (209–11).[15]

Obviously, I do not mean to suggest that Ciepley has deliberately constructed a rationale for Nazism. Rather, he unintentionally arrives at such a rationale because he concerns himself solely with means to the exclusion of ends, and overlooks the fact that skilled, "responsible" political leaders and efficient, incorruptible bureaucrats are a menace rather than an asset when the ends to which they put their expertise are undesirable ones.

The connection between this issue and the question of voter control of public policy is, of course, one of the oldest rationales for democracy: a polity controlled by voters is more likely to serve the interests of the people than one in which bureaucrats and politicians have free rein to pursue whatever ends they choose. Indeed, the greater the skill and professionalism of the politicians and bureaucrats, the *greater* the harm they might potentially do, and the more imperative the need for voter control. Hitler and the German bureaucracy were especially dangerous, in part, precisely because they met Ciepley's criteria so well. A less capable *Führer*, saddled with a less efficient state apparatus, might not have succeeded in conquering Europe or organizing the Holocaust.

Obviously, a state constrained by the power of voters may also commit wrongs. Even constrained power can be abused, and voter control is not a panacea. But it is surely preferable to its absence.

To avoid misunderstanding, I must reiterate that I do not regard my arguments here as any kind of final resolution of the issues they address. The questions of the feasibility and desirability of limited government, of the relative informational problems of private- and public-sector decision making, and of the quality of political leadership in different types of polities are all far too complex to be settled here. I hope to have accomplished the much more limited task of rebutting several of Ciepley's criticisms and raising doubts about his "Weberian" defense of democracy. Nonetheless, the issues he raises deserve much more extensive and systematic investigation than has yet occurred.

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NOTES

1. Indeed, I explicitly excluded any comparative evaluation of public- and private-sector information problems (Somin 1998, 446–47).
2. State governments employed approximately 600,000 people in 1929, compared to just under 4.6 million in 1992 (ACIR 1994, 11, Table E)—approximately an eightfold increase. The population of the United States has roughly doubled since 1930, thus yielding the figure of a fourfold expansion in per-capita state-government employment.
3. These figures address the *size* of state government rather than its *scope*. The latter is much more difficult to measure. However, the figure for state employment is a partial indicator of scope, since an increase in the number of officials usually implies an expansion of the range and complexity of governmental functions. Moreover, it is difficult to deny that the twentieth century saw a vast assortment of new forms of regulation at both the federal and state levels (Higgs 1987).
4. Except possibly with respect to a few atypically simple and highly prominent issues, as I noted (Somin 1998, 427).
5. This particular argument for minimizing the importance of voter ignorance is not a new one. See, e.g., Schattschneider 1960, 132–34.
6. This ignores for the sake of simplicity cases in which private consumption decisions are made by groups such as families, partnerships, or corporate managers. For present purposes, these cases do not differ materially from situations in which the consumption decision is made by a single person, because in these cases, the number of people involved in the decision is almost always small enough to avoid collective-action problems. For more complete explanations of the relationship between collective action problems and group size, see Olson 1965 and Hardin 1982.
7. More technically, they devote almost no time to acquiring information *for the specific purpose* of improving the quality of their vote. They do acquire some, though usually not much, political information as an incidental element of activities undertaken for other reasons. For example, some politically relevant information is obtained through ordinary life experience and through books, TV programs, and movies that people watch for entertainment purposes (Popkin 1991).
8. In fact, not everyone agrees that national defense is a public good (see., e.g., Friedman 1973 and Rothbard 1978). However, I assume here that it is, for purposes of argument.
9. For evidence and arguments that the private sector can often overcome public-goods problems on its own see, e.g., Ostrom 1990, Ellickson 1991, and Schmidtz 1991.
10. See Lieberman 1989 and 1994 for cogent theoretical and empirical discussions of how market mechanisms can effectively handle information problems in the area of educational choice, one of the most complex and difficult cases.

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11. To consider only the three complex goods I mentioned (houses, cars, and education), there is an assortment of independent information on car quality, such as that available through publications such as *Consumer Reports* and *Automotive Weekly.* A visit to any book store is enough to discover dozens of college and secondary school guides. There is a similarly large range of compilations of information on real estate, as well as independent assessors who specialize in examining real estate to determine its true condition. I do not have the space here to examine why the capture predicted by Ciepley does not occur. However, one conjecture is that private-sector consumers are less likely to be deceived by "captured" watchdogs than voters are because consumers have more of an incentive to be well informed. A second possibility is that less-informed consumers are able to piggyback on the efforts of more-informed ones, who are likely to demand unbiased information. The latter, of course, are much more common than well-informed voters. See Lieberman 1989, 1994 for a similar argument in the context of educational choice.
12. Perhaps sensing this contradiction, Ciepley argues that the really important form of competition is that which teaches the potential leader to "fight with words" (214)—a criterion that he believes favors democracy, as evidenced by the prevalence of verbally skilled lawyers among democratic politicians. However, many dictators have also been great orators, as witness the case of Hitler; and Ciepley does not explain why verbal agility is in any way necessary for effective government. Among the many reasons to doubt this claim is that powerful oratory can be used to justify bad policies no less than good ones.
13. For the classic account of Hitler's political leadership on which this summary is primarily based, see Bullock 1964. For a discussion of Hitler's surprisingly consistent and sophisticated world view, see Jäckel 1981.
14. The one possible exception is that Hitler did not, as Ciepley would have him do, take full account of "the moral complexity and ambiguity inherent in all human endeavors" (220). Yet any attempt to balance competing imperatives seems to conflict with Ciepley's simultaneous injunction that the ideal political leader be highly committed to a unifying ideal for his nation-state, and even for the world (219–20). Moreover, although Hitler was unwilling to give any credence to the ethical precepts of his opponents, he often displayed an understanding of their views—for example, in using the weaknesses of liberalism against his adversaries by exploiting their policy of "appeasement" (Bullock 1964).
15. To take one example: as Hannah Arendt (1963) famously noted, Adolf Eichmann was a fervent exponent of ideals of bureaucratic professionalism similar to those espoused by Ciepley.

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Jeffrey Friedman

AFTER DEMOCRACY, BUREAUCRACY? REJOINDER TO CIEPLEY

ABSTRACT: *In a certain sense, voluntary communities and market relationships are relatively less coercive than democracy and bureaucracy: they offer more positive freedom. In that respect, they are more like romantic relationships or friendships than are democracies and bureaucracies. This tends to make voluntary communities and markets not only more pleasant forms of interaction, but more effective ones—contrary to Weber's confidence in the superior rationality of bureaucratic control.*

Max Weber's inaugural editorial for the *Archiv für Sozialwissenschaft und Sozialpolitik* (Weber [1904] 1949) provided the inspiration for *Critical Review*. If anyone were to assert that this journal comes close to the standards set by the one Weber edited, it would be flattery of the highest order. But at least now, thanks to David Ciepley's major contribution, it can be said that these pages have begun to devote to Weber the attention he deserves.

Even Weber was human, though, and Ciepley, in his Reply to me (Friedman 1998) and to Ilya Somin (1998) in *Critical Review* 13, nos. 1–2, spotlights one of our hero's most dubious claims: that bureaucracy is the most instrumentally rational means of organizing people. To be sure, this claim is integral to Weber's broader portrayal of modernity as an iron cage from which escape is, at best, difficult—all the more so because the cage is so instrumentally rational to be in (e.g., Weber 1978,

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1402). Thus, rethinking Weber's assessment of bureaucracy in the way my article suggested will entail amending his picture of the human situation. Our predicament is, I think, both more dire (because it is not so rational after all) and less inevitable (for the same reason).

These departures from Weber are nicely reflected in Ciepley's response to my notion that democracy and bureaucracy suffer more from the problem of public ignorance than do markets and nonpolitical communities. Compared to my assessment, Ciepley's view of our situation is faithful to Weber in being both more benign and more "mature" (in the Weberian sense): democracy and bureaucracy aren't so bad, and we'd better get used to them.

So I will put in my pitch for a little "immaturity": a possible escape route from the iron cage, but one that doesn't require us, as Weber would, to follow a charismatic leader who will use his lawyerly training to fight (with words, at the very least) for our Nation's ideals. Maybe the iron cage is our fate; but we shouldn't reach this conclusion from the premise that bureaucracy is the most rational form of organization.

The Instrumental Irrationality of Bureaucracy

In order to properly assess Ciepley's endorsement of bureaucracy, it may help if we step back and figure out exactly what makes for bureaucratic "rationality"—or rationality in a market, or in a nonpolitical community. (I will make less frequent references to democracy, since Ciepley defends only Weber's heavily bureaucratized version of it.)

When Weber apotheosized the instrumental rationality of bureaucratic organization, he clearly meant its effectiveness as a form of power that gets people to do things they otherwise wouldn't. But how do people actually experience bureaucracy and its competitors—in this case, nonpolitical communities and markets? The answer to this question may bear on Weber's claim for the instrumental rationality of bureaucracies, because the feelings of someone enmeshed in such an organization—the "value rationality," or *intrinsic* value,[1] she finds (or fails to find) in it—may well affect how she responds to its constraints. If her response is to struggle against the constraints, they may turn out to be less effective than Weber believed. And even if she passively accepts her iron manacles, efficiency may not be the end result.

Taking a page from Foucault with which, I think, Weber would ultimately agree, one might say that nearly all human relationships are ex-

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ercises of power. In all relationships the participants either agree or disagree with each other about how they should behave. If they agree, they need not coerce each other. If they disagree, they either keep quiet about it or try to influence each other to behave as they wish. If they keep their differences to themselves, then they *effectively* agree about how each other should behave—all things considered. But if their disagreements are strong enough, they will try to influence each other's behavior, and in doing so they will have to use enough coercion to get the other person to do what he resists doing.

Usually this coercion takes the form of a threat or a reward that has the *psychological* power to seduce, persuade,[2] cajole, browbeat, or frighten someone into doing what someone else wants. Even threatening to beat someone up is mere psychology; no line has been crossed into the realm of brute force. And when that line is crossed, the effect is merely to inflict on our victim a *different* type of pain, physical rather than psychic, not necessarily a *greater* type—but still in the attempt to alter his psychology and thus his behavior.

The less violent psychological pressures are directed toward the same end as is the infliction of bodily harm: changing another's will so as to elicit desired behavior. On the one hand, even physical torture may fail to coerce effectively. On the other hand, receiving an electric shock to the soles of one's feet may be less devastating to the victim, and less potent in altering his actions, than a glance, a gesture, an unkind word, or the unspoken threat of disapproval. Indeed, we often subject ourselves to physical pain (by exercising, for example) so as to avoid the possibility of a psychological slight (sexual rejection, for example).

Strictly speaking, only the type of physical coercion that grasps someone's body and moves it one way or another against his will actually forces him to do anything. Every other kind of "physical coercion" inflicts or threatens physical pains that may be less effective than real or threatened psychological pains in achieving the coercer's goal: persuading the victim to cooperate, of his own free will. Just as he might freely decide not to walk north on a certain pathway because he knows that if he does, he will fall off a cliff, he might freely decide not to say something he had a "right" to say because he's been warned that if he does, he will be pushed off a cliff.

Liberal theorists often like to distinguish coercive interactions from those that are merely persuasive or otherwise voluntary, even though the interactions in question alter, or aim to alter, others' behavior. Making such distinctions is one role "rights" play in liberal theories. But

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there is no way to mark off as "noncoercive" some of the means by which people change each other's behavior that is not, in the end, parasitic on a pre-existing ethical system that establishes the right to take certain actions, which are then categorized as "noncoercive"—which simply defines out of existence the coercive element in such actions (cf. Cohen 1979; Weinberg 1997). One may, of course, taxonomize to one's heart's content, but it should at least be recognized that no matter what we call it, there is something in common among all attempts to push people around; and that this something is present whenever one is threatening, or inflicting, either physical or psychological pain on a recalcitrant party if she does not act as one desires—even if we hold that one has a "right" to threaten or inflict that type of pain.

The liberal urge to classify some types of psychological or physical pressure as noncoercive stems from the fact that ultimately, liberals value equal freedom above everything else, making them reluctant to admit that coercion is omnipresent—and a society of equal freedom elusive. Acknowledging the ubiquity of coercion, however, makes for a more realistic picture of the effects of different types of it than does labeling some of them noncoercive. For example: if, as I have been supposing, some forms of coercion have far more psychological (and therefore behavioral) impact than others, Weber's assumption that the ideal-typical bureaucratic relationship is the most effective way to control people's behavior loses a great deal of its plausibility. If you really want power over someone, first get him to fall in love with you, or wave a gun in his face. Issuing him a bureaucratic directive is a routinized but, for all of that, far less "compelling" form of compulsion than virtually any other that could be named. This may be why, contrary to Weber's all-too-Prussian perspective (e.g., Weber 1978, 1400), the economic literature on bureaucracy—for once confirming daily experience—tends to be about slacking off, evading responsibility, desultory performance, and bungling—not about crisply following ultra-logical, scientifically determined orders. (But perhaps mine is an all-too-American perspective.)

Love, Friendship, and Capitalism

Even in truly noncoercive relationships—relationships characterized by agreement—*power* is ubiquitous, although it is not exercised. Presumably we wouldn't be in a relationship with someone if it did not have some kind of value for us (instrumental if not intrinsic). This means

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that the person with whom we are relating has, at the very least, the power to end the relationship and deprive us of what we want. If one's beloved disagrees with the behavior of her lover, she can deploy her power to try to get him to act as she desires. But even if she concurs with his behavior, she retains latent power over him.

Power also lurks in more routinized interactions, whether or not it is actually exercised. This applies to market institutions and voluntary communities as much as to bureaucracy or any form of political governance; but in commercial and community relationships, power—I will argue—tends to be exercised more pleasantly, or not to be exercised as much, as in political and bureaucratic relationships. This is due to the greater degree of agreement among the participants in commercial and community relationships than among those in bureaucratic or, say, democratic political relationships.

Although we cannot philosophically mark out some of the actions that alter others' behavior as noncoercive, or even grade such actions as "more" or "less" coercive, there remain psychologically qualitative differences between exercising and failing to exercise power, as well as differences in the harmfulness of various types of coercion. These differences aren't without their significance. Is there any doubt that we are happiest when we are freest, in the sense of being most in accord with each other—and therefore less in need of pushing or being pushed around? Total freedom may be impossible, but freedom in more situations, and freedom from the most unpleasant forms of coercion, can still be valuable.

For that reason, loves, friendships, and more expansive forms of interaction grounded in common desires and interests—such as voluntary communities and markets—can be attractive not just if we take the freedom they embody to be intrinsically important (as so many liberal theories do), but if we take it to be instrumental to our well-being. When we have to manipulate each other or be manipulated, it does not feel good. It feels much better when we agree with each other about how to act.

Consequently, I suspect that bureaucracy tends to be not only instrumentally but "intrinsically"[3] inferior to relationships that are less dependent on coercion. The bureaucratic enforcement of formal rules of behavior is necessary only *among people who disagree with each other.* And it is only when the rules are enforced that they become anything but *mere* formalities. In the real world, bureaucratic rules translate into flesh-and-blood people bossing each other around (or threatening to do so): for-

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malism itself becomes a mere formality, replaced by something approaching personal authority. The boss is no longer a friend if he refuses to look the other way when his subordinate has broken a rule. If we assume that bossing is nearly as unpleasant as being bossed, then in his role as policeman, the boss's lot is not a happy one—nor is that of his underling.

When Weber extols the bureaucratic ethos of rule-following, he may well be making a virtue (literally) out of a necessity. As Weber sees it, early forms of social power were based on the loyalty to an organization's aims that was induced by one's charismatic attachment to a leader—or, at the dawn of modernity, by one's sense of a calling to pursue the organization's goals, or to do the type of work one could do in the organization. But later, as people began working in organizations to which they were not so deeply committed by internal motives, it stands to reason that they could no longer be trusted to supervise themselves. Taskmasters would have had to be placed over them and rule books written to guide their behavior, using coercion to tame what would otherwise be the employees' preference to pursue ends other than those of the organization, or to use unauthorized means to those ends. The shift from internal to external enforcement of the organization's imperatives cannot have been "agreeable"—almost by definition—to the employees. What it *means* to want to do something unauthorized is that one will be less happy doing what is authorized. Bureaucracy, in this telling, is widespread because when the world becomes so "disenchanted" that charisma and a sense of calling are no longer adequate, a new mechanism of obedience is needed to get people to advance the aims of the organization.

What Weber does not seem to have recognized, however, is the inherent instability of a system in which one's motive to do as one is told is, to a large extent, supplied externally, through the coercion of one's superiors. In this light, the vaunted Prussian bureaucratic ethos—according to which the subordinate considers it "his duty and even his honor to carry . . . out as if it corresponded to his innermost conviction" orders that "he considers wrong" (Weber 1978, 1404)—may be an attempt to stabilize bureaucratic interactions by supplying the employee an internal motive for obeying orders: a sense of obligation. One is reconciled to doing that with which one disagrees by making obedience itself one's calling.

Even in the best-case scenario, however, under which the bureaucratic ethos has been effectively inculcated, the mere fact that the sub-

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ordinate may disagree with orders he feels he must follow would seem likely to reduce his energy in following them, to say nothing of his creativity in finding more effective modes of achieving the goals toward which the orders aim. In short, to the extent that the bureaucratic ethos has been successfully inculcated, the bureaucrat's efficiency will be diminished, not enhanced; and to the extent that the ethos has *not* been internalized, such that the employee insists on being entrepreneurial out of enthusiasm for the organization's "cause" (or a cause of his own choosing), he will risk incurring coercive sanctions—which may not only demoralize him, but, once more, stifle his effectiveness.

Market exchanges, by contrast, while constrained by a panoply of involuntarily imposed legal rules, are, in themselves, distinguished by their foundation in agreement: agreement over the narrow issue of this good, for this price, at this time. The system works, as if "by an invisible hand," as long as we obey (through coercion, if necessary) property rules ensuring that we enter into only those exchanges that we think will benefit us. Obedience to those rules renders all resulting transactions "agreements" in a real sense—and it renders the ideal type of a market interaction psychologically pleasing, for just the reason that a bureaucratic interaction is not.

Because the topics of agreement at the point of sale can be so narrow, the market can operate not only automatically, but (in the ideal type) with complete impersonality. The terms of exchange can be defined precisely enough that buyer and seller need never even meet each other (let alone like each other). This anonymity—and the false bonhomie that is required to please customers or other potential parties to an exchange when market participants *do* meet each other—are artificial, inhuman, and alienating forms of interaction. But they are far less unpleasant than more natural relationships can be—when the latter are characterized by disagreement. Because you are *willing* to engage in trade with me (if only because the operation of the legal framework has made you desperate to buy what I'm selling, or to sell what I'm buying), I need not directly coerce you to complete the sale; and if I try to coerce you indirectly by manipulating you in unpleasant ways (such as bombarding you with annoying advertising, or assigning you to an overly bureaucratic workplace), you can—*ceteris paribus*—walk away from the unpleasantness, because I have no personal claim to the continuation of your relationship with me as customer or employee.

What is "capitalistic" about capitalist interactions is that, to use Albert Hirschman's (1970) terminology, one may "exit" from them. This is

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what produces the potential for competition among suitors for customers', or employees', or employers' agreement—hence for their trade—if a customer, employee, or employer is dissatisfied with her current market relationships.

Why, then, are coercive, disagreeable, reduced-exit employer/employee relationships so commonplace under capitalism? Why is it that corporations as well as governments are bureaucratic? I cannot improve on the suggestion of Ronald Coase: that capitalist bureaucracies arise when the services being purchased are so varied that it would be more costly to contract for them on each occasion than it is to contract for a sort of eight-hour-a-day servitude, in which the employee may be ordered to do many different things. As the point of agreement becomes less precise than in the ideal type of an anonymous purchase, relationships become less distinctively capitalistic, more personal, and potentially more coercive. And given modern disenchantment, we find often enough that the power latent in these relationships—the power of the employer or the manager to influence employees coercively—must be exercised.

Even in its nonbureaucratic ideal type, however, capitalism is far from being uncoercive. The members of any society must live under a given body of property law, and since they must also live with the "distribution" of property to which the law leads—even if they would like it skewed more in their direction—there must be a background of coercion to keep them in line. This is as true of capitalism as of any other system; and since every society (in its ideal type) enforces its property rules just as effectively as the others, it cannot rightly be said that the laws of a capitalist society are any less coercive than those of a Communist state.

But a coercive legal background is no *more* characteristic of capitalism than of any other system (except a utopia such as Marx's, where our nature as species-beings presumably brings us into automatic agreement about everything). And the coerciveness of the laws enforcing capitalist rules of exchange afford people more flexibility, room for choice, and thus "positive" freedom[4]—freedom to do *as they will*—than various other types of law because, given that there has to be *some* coercive legal background (and ignoring the crucial question of whether a more egalitarian legal background would, in practice, be even better than capitalism at maximizing equal positive freedom), capitalism guarantees greater scope than democracy, or Ciepley's bureaucratic democracy—where the bureaucracies are government agencies—for exiting (or

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never entering) relationships the participants find either intrinsically unpleasant or instrumentally unprofitable. What makes some relationships worth marking out as peculiarly "capitalistic" is that in them, we needn't confront each other with our disagreements, as must competing political partisans, or bureaucrat and subordinate, or parent and rebellious child, or friend and disagreeable friend, or beloved and discontented lover. Customer and merchant do each other's bidding only when they agree on some narrow issue; where they disagree, they have no dealings with each other. Their relationship is *ultimately* coercive, in that on the broader question of the distribution of wealth, a given consumer might like to have the merchant's riches, or a worker might like to trade places with her employer, or an intellectual might like to see the whole property system altered or abolished. Such dissidents may well have to be constrained by the threat of police intervention if capitalism is to work. But at the purely superficial level at which most of "civilized" (post-hunter-gatherer) life is lived, capitalist coercion comes packaged in a latent form that is, therefore, far more soothing than its bureaucratic rival. (This, I take it, is what so annoyed Marx about "commodity fetishism.")

The Instrumental Superiority of Markets and Communities

The constrained voluntariness of capitalism explains, of course, not only why, compared to bureaucratic power, it is relatively pleasant; but why it is relatively efficient. The ability to walk away from a given deal produces competition among those who would like to lure potential partners in exchange out of the deals they are now in; and once a medium of exchange is discovered that can be used to compare various quantities of different goods, a network of prices can arise. Getting someone to agree to exchange with you by having him compare the price of your offer to the prices of other goods is far more effective than writing out detailed rules for his behavior, and then confronting him face to face when he breaks one of them.

To repeat, a theoretically invariant amount of legal coercion must be deployed to enforce the legal framework within which any society's interpersonal relationships occur. But within such a framework of coercion—which constrains people in bureaucratic relationships as well—capitalism allows relatively numerous opportunities to exit from relationships of disagreement. This enables people to go about the busi-

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ness of finding common ground with, in effect, millions of strangers in a far more effective (and "agreeable") way than if they had to articulate or even think very much about their differences with each other.

The same is true, on a smaller scale, of noncommercial, nonbureaucratic communal relationships. Unlike the political "community" of a democracy, which encompasses everyone within a certain geographical jurisdiction, nonpolitical communities—although also constrained by coercive legal rules—are voluntary in that they allow people to exit (or never to enter) the community if they come to disagree with its goal, or with the means by which it is being pursued, or with anything else about the community. Democratic political "communities" are inefficient and unpleasant precisely because they block one's exit, rendering agreement less likely than if exit were open. In the face of disagreement—the normal modern condition, except in unusually homogeneous communities—one can get one's way in a democracy only through what Hirschman calls "voice": the deployment of rhetoric, the manipulation of others' ignorance, dissimulation, and all the other things that Weber and Ciepley recognize as synonymous with democratic politics. This brings me to my first direct disagreement with Ciepley. The notion that leaders who excel in the persuasive arts will tend to be good judges of public opinion is plausible; but judging public opinion is hardly the same thing as judging individuals. I do not understand how Ciepley is able to infer that a demagogue, because he is good at assessing which half-truths will sound plausible to the voter, is therefore good at assessing individuals' character. (This is to say nothing about the even more dubious claim that judgments of character can produce reliable judgments of expertise.)

Unlike democratic citizens who are members of a polity whether they like it or not; and unlike members of bureaucracies who have chosen to work there for the sake of emoluments and security (Weber 1978, 1400); people who volunteer to participate in a communal project have a relationship with each other (at least ostensibly) only for the sake of the project itself. Their participation is not subordinated to the more distant end of the things a paycheck can buy—the capitalist part of bureaucratic relationships. Nor is their behavior commanded and shaped by coercion—the bureaucratic part. Although a nonpolitical community is more cumbersome than an ideal-typical market (because the signaling mechanisms at work are rarely impersonal), such a community can be expected to be more efficient than a bureaucracy in achieving its goal, for the same reason it is predictably more pleasant: participation

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in it is premised on people's agreement on the desirability of participating. The members of the community, unlike democratic citizens or bureaucratic employees, interact with each other in the first place because of their enthusiasm about a common project.

The fellow feeling, the "sense of community," that grows from this common ground may be so enjoyable that it comes to be valued in itself (or as a direct means to the personal end of happiness)—unlike most market exchanges, which, stripped of personal interaction, are at best psychologically indifferent. That much—the "intrinsic" satisfaction of community—is well known; what may not be as widely recognized is that on a strictly instrumental basis, community volunteers, freed from the constraints of either consumer demand or bureaucratic edict, have the freedom—and the desire—to come up with creative ways to get things done that may make them more effective than either bureaucracies or capitalists. (Communities may be more effective than capitalism either because the communal project involves helping people who lack effective consumer demand; or because personal interaction with the project's "consumers" is required to accomplish its aim; or because community members are at the same time "consumers" and "producers" of their project's "product").

The relative desirability—both psychological and instrumental—of markets and communities flows from the possibility of exit. If a commercial or communal relationship is unattractive, one may end it: that, in essence, is what makes it commercial or communal rather than bureaucratic or political. The exit option, of course, exerts a psychological cost: instability. But because of the public's ignorance, democracy is also unstable; and bureaucracy may be even more unstable than the market once its rules have proliferated to the point at which their enforcement becomes arbitrary. On the other hand, market and communal instability are but subspecies of the overall insecurity that also infects friendships, romantic relationships, and family life when the exit option exists, and this insecurity exerts pressure on people to take their interactions more seriously. It may therefore be partly responsible not only for the endless fascination with psychology and personal relationships that marks modern cultural forms, such as the novel; but for a sensitivity to each others' feelings, and an empathy for our power over each other, that may prompt larger numbers of us, over time, to avoid commitments we are not sure we can keep.

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Policies vs. Products

Ciepley overlooks the centrality of exit to the feedback markets and communities provide (not that I mentioned it) in rejecting the idea that, in coping with public ignorance, the "private sector" may pose an instrumentally rational alternative to Weberian bureaucratic democracy. Ciepley's chief objection is that "dearth of feedback is a function not of who is providing the good, but of the nature of the good provided" (1999, 201). Thus, he suggests that the bureaucratized democratic state provides goods that would not be improved upon by less coercive arrangements: we elect political leaders

> to do things like determine trade policy. Here the feedback is indeed opaque—difficult both to isolate and to interpret (consider the debate over NAFTA). But we'd get no better feedback if trade policy were set by a private corporation (as the case of the East India Company suggests). (Ciepley 1999, 201)

The idea, however, is not that *privately owned* organizations somehow deal better with ignorance than public ones. Instead, the idea is that the markets and communities that compose the non-state sector (civil society) have an epistemic advantage to the extent that they allow exit options, hence potential competition. (Indeed, only to that extent am I defining them as markets and communities, rather than as states.) A private corporation setting "trade policy" is as much a no-exit monopoly as is a state; indeed, like the East India Company, it is simply an appendage of the state, or a state bureaucracy guided by the profit motive. But the profit motive is not what differentiates markets from states; it is the possibility of exit. The state is whoever uses the Weberian "*monopoly* on the use of force" to prevent competition (of various kinds) within a geographical area—that of the "nation-state."

To take Ciepley's example, if there were exit options in matters of "international" trade, the result would look like the East India Company only in the unlikely event that one company managed to buy and sell, to the satisfaction of all the inhabitants of a nation-state, all the trade goods from "abroad" that the inhabitants wanted to sell or buy. Even in that case, what its customers would be evaluating when they bought and sold goods through this huge company would not be its "trade policy" per se. That would, as Ciepley recognizes, place almost impossible epistemic demands on them. Rather, they would be evaluat-

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ing individual products that provide much more interpretable feedback about their "goodness" than does "trade policy." Indeed, there would be no more need for an international "trade policy" to exist—let alone for it to be set by any authority (public or nominally private), let alone for it to be assessed by voters or their agents—than there is, at present, a need for a *national* "trade policy." Trade would be conducted between parties that agreed to exchange with each other: parties that had the option of not trading, if they failed to come to terms. The benefits of engaging in relationships that people think will improve their lot would extend unimpeded across the artificial borders of nation-states, and the theoretical knowledge required to set the terms of international trade for hundreds of millions of citizens would no longer be necessary. All that would be necessary is for the potential participants in each of the billions of bilateral trade relationships that compose the global economy to assess whether a given exchange would benefit *them* as individuals. Undoubtedly, their feedback-driven assessments would often be incorrect. But they would be far likelier to be correct than are theory-driven assessments of what would benefit all the citizens of a nation-state.

Admittedly, in a world economy that is (contrary to the prevailing wisdom about "the triumph of global capitalism") governed by nation-states and their no-exit "trade policies," a hegemon such as the United States can make incremental progress by pushing (through such devices as NAFTA) for freer trade than is currently allowed. But to consider NAFTA "progress" is to reject the notion that democratic bureaucracies are as well suited to handling epistemic complexities as markets are, since the end point of such progress would be to replace all trade policy with trades of products.

Consider a different example: Kevin Dowd's construction, in these pages (Dowd 2000), of the ideal type of a laissez-faire monetary order against which to judge the widely bruited notion that "laissez faire" describes contemporary international finance (as opposed to contemporary international trade). Dowd conducts a thought experiment in which states have no role in "monetary policy." What this means is not that consumers would then have to assess the wisdom of the monetary policy undertaken by a privatized monetary authority—or even the wisdom of the monetary policies of competing banks, each issuing its own currency. Consumers of money would no more have to evaluate the macroeconomic theories used by the competing banks than they have to understand, right now, why one bank offers more ATMs or better service or higher rates than another; or why Subarus are better

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than Hyundais. Expertise in the banking or automotive industries is nice, and might even be helpful, but for the most part it is made unnecessary because most consumers can rely on the feedback provided by their own experience—and the experiences of others whom they trust (some of whom might possess such expertise)—to tell them which car, or which bank, or which currency, is reliable.

My difference with Ciepley on this point amounts to registering an objection to his conflation of "the nature of" goods that happen to be publicly provided with goods that *have* to be publicly provided. Goods that are publicly provided, we agree, will tend to produce little in the way of feedback that would allow a voter or a politician to make wise "policy." But what characterizes the "nature of a good provided" by states is not necessarily that it is a "public good" in the sense of a good that *must* be provided by states (or their agents). Rather, what characterizes goods that *are* publicly provided is that the state uses its legal power to ensure that there is no possibility for consumers of the good to go elsewhere: the state uses its monopoly on legitimated violence to create a monopoly in the provision of a certain good, for which political decisions about "public policy" then substitute for the decisions of individual consumers about how good the product is. If exit and thus competition were allowed, then *nobody*—let alone politicians or voters—would have to decide (on behalf of *everyone*, and therefore in a manner that is bereft of easily interpretable feedback) "trade policy," "monetary policy," "education policy," "health policy," etc. Such policies would not even exist, except in the sense that Subaru, Hyundai, and their competitors have "automobile-production" policies. These policies are evaluated by consumers' reaction to the feedback generated by the cars they buy—not by consumers', or politicians', grasp of the policies themselves.

The only type of "policy" that is inherently "public," and thus must be subjected, in a democracy, to direct assessment by voters, politicians, or those they appoint, is the policy involved in producing a good that cannot be produced if exit is allowed (cf. Cowen 1992, Schmidtz 1993, and Varian 1993). Only with such truly public goods is it true that, as Ciepley contends, "dearth of feedback is not a function of who is providing the good, but of the nature of the good provided."

When the exit option is impossible—as with some forms of air pollution, military defense, and of course the elucidation and enforcement of property law—then, indeed, it is the nature of the good, not of its provider, that leads to ignorance about how much of it, what type of it,

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and so on, should be produced. In using the example of military preparedness, I was not suggesting that public ignorance could be ameliorated by turning defense over to "a private firm" (Ciepley 1999, 201). Rather, my point was directed against Somin's idea that reducing the number of government tasks would diminish the public's ignorance of the tasks that remained. Precisely because, in this case, "the nature of the good" precludes an exit option, useful feedback would likely continue to be scarce, and military policy correspondingly irrational, no matter how many other items were on the public agenda, and regardless of whether "defense policy" was made by a "private" corporation.

Democracies vs. Markets

Part of Ciepley's argument is that useable feedback about the quality of certain kinds of goods is scarce by nature, regardless of who (government or "private" corporation) provides it. Another part of his argument is that feedback about *who is responsible for* the quality of such goods is also independent of their public or private provision. So while he agrees with Schumpeter (1950, 263) that "the picture of the prettiest girl that ever lived will in the long run prove powerless to maintain the sales of a bad cigarette," Ciepley (1999, 201) contends that "if presidents were elected to provide quality cigarettes, we'd know a good president from a bad one as surely as we know a good cigarette from a bad one."

I cannot entirely go along with him about that. It *may* be that the *demos* will accurately blame its leaders when things go wrong; but since a democracy relies so heavily on "voice" to replace exit, it strikes me as plausible that politicians will sometimes be able to shift the blame to "evil" others—such as the encircling capitalists who for decades, to take Ciepley's example, were blamed, with a great degree of success, by Communist leaders for the defects of their societies; or the greedy electric companies that are now being blamed for the California energy shortage.

The rhetorical skills for which democracy (even more than Communism) selects can capitalize on public ignorance to make such claims credible. But as Schumpeter pointed out, capitalists use the rhetorical arts too—in their advertising. Still, even if the rhetorical skills of politicians and advertisers are equivalent; and even if, therefore, democratic citizens would be able correctly to identify the source of, say, bad cigarettes produced by a state monopoly as much as capitalist consumers

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can do so; there is another problem. Citizens, unlike consumers, have no effective recourse when they encounter negative feedback. Even if we all agree that our cigarettes taste bad because of incompetent political leaders (but how would we know what tastes "bad" if the lack of exit has deprived us of the ability to try other brands than the one produced by the state?), what could we then *do* about it?

When cigarettes are privately provided (i.e., competition is not legally obstructed, so exit from one brand is possible), adventurous consumers under the influence of an ad for a "new, improved" cigarette may be prompted to repurchase it if it turns out to be superior to the old brand. This would enable the new manufacturer to buy more of the services of advertisers whose work would further build up the cigarette's brand name. An advertising blitz would, in turn, tend to generate more sales by signaling less adventurous consumers that the new brand is popular enough that it may be worth trying.

By contrast, "customers" of a democratic state's cigarette monopoly, lacking the opportunity to act on their dissatisfaction by buying another brand, would be subjected to one kind of cigarette per political regime, even if they could identify the regime as the source of the brand's defects. Those who were dissatisfied with the current brand would have to wait until the next election to switch brands—*if* they could (somehow) persuade a majority of their peers that a brand they had not yet tasted would be worth voting for. The "long run" over which Schumpeter pointed out that advertising could not maintain the sales of a bad cigarette will arrive only if consumers are *individually* free, in the short run, to be seduced by a variety of advertising campaigns, until enough of them get enough varied feedback to be able to ignore the seductions of bad cigarettes. Public decision making—decision making that allows no individual exit—slows things down so much that the long run may never arrive.

None of this is to suggest that Ciepley advocates a government cigarette monopoly. But his example does neatly illustrate the potential for superior feedback, and corrective action, on the two matters he identifies as leading to public ignorance: the difficulty of assessing both the quality of public policies and the responsibility for it.

I should add that *democratic* public decision making replaces relatively pleasant (if banal) commercial attempts at "persuasion" with the distasteful, demonizing demagoguery with which any observer of politics is familiar. Neither the photo of a model nor a catchy slogan is usually enough to persuade people to switch party "brands" when so much

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more than cigarette choice is at stake, and when the new "brand" cannot be sampled without saddling oneself with it for an entire term of office. The bigger the stakes and the scarcer the feedback, the bigger and harsher the lies.

State vs. Private Bureaucracies

Since Ciepley finds markets and democracies to be equally incapable of dealing with public ignorance, he turns, like Weber, to a combination of the democratic state and bureaucratic organization as a (partial) solution. Like Weber, Ciepley is impressed by the bureaucrat's ability to govern more wisely than either an ignorant voter or an ignorant consumer. This is because like Weber, Ciepley seems to assume that bureaucracies are chiefly characterized not by their hierarchical, rule-issuing coerciveness, but by their expertise. So—to return to the cigarette example—fearing possible reprisals from the voters, a democratic political leader could simply rely on the expertise of her cigarette bureaucracy to produce a "good" cigarette.

But the bureaucracy wouldn't have produced a bad cigarette to begin with if, indeed, bureaucracy is rule by experts. Ciepley's emphasis on bureaucratic expertise (following Weber's) is both exaggerated and beside the point. In the *state* bureaucracies Ciepley defends, "expertise" is measured by success on examinations and by length of tenure. To equate such measures with "expertise" vastly overstates the ideal-typical bureaucrat's immunity from the problem of ignorance. Are skill at taking tests and at surviving office politics really the qualifications we want in a cigarette manufacturer—or, to take up Ciepley's other examples, a dress manufacturer, a general, or the designer of trade policy?

Maybe such skills are not so much *good* indicators of expertise as they are the best we can do. But in that case, there is no reason they could not be adopted by *market* bureaucracies. A corporation whose bureaucracy mimicked the hiring practices of state bureaucracies would, if Ciepley is right, produce the best possible product. Consumers would flock to buy it, and its competitors would either be driven from the field or driven to adopt the same methods. At worst, then, market bureaucracies would be no less efficient than state bureaucracies. But at best—if there are, in fact, better criteria of expertise than exams and years of service—then market competition would be expected to find those criteria, producing an epistemic edge over state bureaucracies.

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Whether examinations and years of service measure true expertise, however, is probably irrelevant. The plain fact is that even true experts—experts in the project at hand—very often *differ* with one other. Given the starting point of Ciepley's exchange with me—that the problem of public ignorance is real, and that it is ultimately due not, as Somin maintained, to the *irrationality* of becoming politically well informed (given the insignificance of any one vote), but to the *impossibility* of being politically well informed (given the complexity of modern societies, and the infinity of the state's mandate to intervene)—it follows that experts will almost necessarily disagree about what should be done, and that expert consensus is as likely to indicate the "experts'" common reliance on a simplifying heuristic—such as ideology—as to indicate that they have discovered an unquestionable truth.

I must acknowledge that this claim will seem implausible to many readers, while others will find in it the essence of common sense. I can only say that which side of the fence one falls on depends on predispositions—heuristics—built up over a lifetime of encountering various claims to expertise. Those who tend to agree with the experts, especially in the field of their own expertise, will tend to view the disagreements among experts as a trivial thing. Those who have disagreed with the expert consensus in their fields—and who have, perhaps as a result, been (overly?) sensitized to the gigantic shifts in opinion that have taken place among experts in other fields (think of medicine, computers, psychiatry, philosophy, and economics—where the consensus now embraces positions formerly staked out by lonely dissident "experts," or by no experts at all)—will, at best, be skeptical of the notion that "expertise" corresponds with "possession of the truth."

Whichever camp one finds oneself in, however, I cannot see that Ciepley (1999, 209) has provided any reason to think that *state bureaucracies* will be "repositories of the local knowledge and expertise required to carry out governmental tasks efficiently and equitably," rather than repositories of local prejudice masquerading as expertise. In concrete terms, how is the voter, or the politician—or the political theorist—to decide *which* experts to employ in a state bureaucracy? This is almost the same question Ciepley asks me when he questions the ability of consumers to distinguish real from phony consumer-product "experts." Since they would need the advice of such experts only if the consumers themselves were ignorant, how could they overcome their ignorance in order to figure out which experts to listen to? Ciepley seems to think that bureaucratic democracy has a way out of this conundrum

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that is unavailable to consumers: the selection of bureaucratic personnel by other bureaucrats—a process Ciepley (1999, 209) calls "experts hiring experts."

Before pointing out the theoretical problem with this solution, let me flesh out just a bit my empirical objection. If, indeed, modern society is a dauntingly complex place—complex enough to require experts on many topics of whose existence even other social scientists are ignorant—then the views of the bureaucrats who are already in place seems no likelier to be true expertise than to be a mere bundle of heuristics for dealing with complexity—no better than voters' reliance on party affiliation, or on economic prosperity, or on whether a polity is at war, or on whether a politician "cares about people like me" (insight into which is largely filtered by mass media with biases—heuristics—of their own). If existing bureaucrats are in charge of hiring their subordinates and replacements, it seems to me that we are likely to get not experts hiring experts, but well-educated ideologues hiring ideologues.

Assume, however, that I am too pessimistic, and that bureaucratic self-perpetuation is as close as we can get to rule by experts. Then what prevents markets from using this method as assiduously as states? (For that matter, what ensures that states will use it?) If bureaucrats hiring bureaucrats produces expertise, and if expertise is important, then competing commercial bureaucracies will find fewer of their customers heading for the exits if this is the hiring method they employ. Moreover, when under capitalism allegedly expert bureaucracies compete with each other, as in Ciepley's example of competitive consumer-protection agencies, their customers can supplement the expert counsel they purchase with direct feedback. If taking the advice of *Consumer Reports* serves me well, then I have a reason to subscribe to it beyond its publisher's untested assertion that it is a fount of consumer wisdom. I am not sure why, even with Ciepley's faith in bureaucratic expertise, he thinks its "repository" is *state* bureaucracy.

One possible reason may be found in Ciepley's analogy between politicians hiring the heads of bureaucracies and corporate boards hiring CEOs—or CEOs hiring managers—who are, in turn, competent at hiring experts. Ciepley's idea is that "his years of political struggle" have made the politician competent at "judgment of people" (Ciepley 1999, 210), just as is the CEO. But once again, even if the analogy holds, state bureaucracies will, at best, be only as expert as the private ones to which they are supposed to be superior—so why foreclose competition with them (i.e., why make them *state* bureaucracies at all?)? Perhaps the

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answer is that *political* struggle—struggle within *democracy*—makes the politician an even better "judge of people" than his private-sector counterpart. But in that case, we would expect the democratic element in corporate governance—the shareholders' meeting—to assume much more than its usual ceremonial role, since corporations that gave real power to their shareholders would find themselves with the most effective CEOs, and thus with the most profits. Again, there is no theoretical case for preferring state to capitalist bureaucracies—or bureaucracy of any kind to *whatever* form of organization emerges in markets and voluntary communities.

Whether one relies on the expertise of existing bureaucrats, or on the character judgments of politicians—or on a rule-following or a "public-spirited" ethos (Ciepley 1999, 203)—turning to state bureaucracy as a source of wise governance has all the appearance of bringing in a *deus ex machina* to magically solve the problem of ignorance. States—whether bureaucratic, democratic, or bureaucratic-democratic—have no epistemological tools that cannot be duplicated by exit-based associations. If voters can choose good experts by selecting for good character, then so can consumers, and commercial competition would take the form of propaganda not about the products, but about the CEOs who picked the experts who designed the products. If an ethos of rule-following, or of public service, could make state bureaucracies efficient, the same ethos could be encouraged, in the same ways, within commercial bureaucracies. If members of the bureaucratic status quo can be trusted to be more expert than anyone else, then commercial bureaucracies, likewise, would rarely make mistakes; but when they did, consumers—unlike the subjects of a state bureaucracy—would be able to turn elsewhere for expertly produced goods.

Instrumental Rationality without Expertise

One would think that if any of the forms of association we have been considering have an epistemic advantage, it would be markets and communities, because exit allows participants in capitalistic and communal relationships to respond to feedback *without* having to acquire exactly what is, at the very least, difficult to find: true expertise about the complex social world. This a priori suspicion is borne out by each of Ciepley's empirical examples.

Take the corporate management-selection process. Because con-

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sumers can stop buying Firestone tires if they start exploding—they can exit their relationship with Firestone and buy a competing brand—a CEO who fails to stop that exodus is likely to be a less attractive candidate for another job than if his stewardship had led to a more profitable outcome. When consumers make the decisions that provide the profit-and-loss feedback against which corporate managerial performance tends to be judged, they need not concern themselves—as they would have to, returning to the earlier example, in judging competing politicians' rhetorical claims for various cigarettes—with what the *reasons* are for the failure of the tires. All they need do is buy a different brand—a possibility opened to them by the greater scope for exit available to them than is open to voters. *Whatever* it is that enables the CEO of the more-successful company to produce better tires, or cigarettes, she will tend to be rewarded for this quality by profits that will give her direct control over more resources than her less-successful competitors, and that will indirectly enhance her reputation as a good manager if she looks for work elsewhere.

It is, indeed, the "competition" (Ciepley 1999, 203) fostered by exit that enables markets (and, in their own way, voluntary communities) to rely on (and therefore to generate) more feedback and less "expertise." The comparative advantage markets and communities have over state bureaucracies is that the exit option enables market and community participants to react to feedback without acquiring an unattainable understanding of why their cigarettes taste bad or why their tires are exploding. The feedback they get from their market or communal relationships is itself the reason for entering into the relationships, rather than being a heuristic for inaccessible information. Where there is competition among entrepreneurs and the managers they hire to realize their idiosyncratic visions, consumers will receive different feedback from different products. Companies whose "experts" deliver bad products will tend to be abandoned in favor of new entrants; and the new products will tend to succeed only if they provide better feedback than the old ones did.

Ciepley's example of the collapse of the American silk industry illustrates the same point. Apparently the synthetic fibers American silk manufacturers used were inferior to the real thing, and consumers caught on. This is precisely a case of feedback driving consumers away, without their needing to understand the source of the problem. Ciepley's speculation about how much better things might have been if only a wise bureaucrat had imposed a "simple government inspection sys-

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tem" (1999, 202) begs the important questions: if such a bureaucrat had existed, what would have ensured that *he* would have been in charge of the inspection system, rather than one of the "experts" who erred in recommending synthetic silk? Conversely: if a state bureaucrat could be aware of the incipient problem, why couldn't his private-sector equivalent have established a brand whose selling point was that it didn't use the cheap synthetics of its competitors? *Somebody* needed to have the foresight of the founder of Ciepley's imagined inspectorate; why is this wise man more likely to have been found in the public than the private sector? Indeed, given the incentives set up by the ability of consumers to walk away from bad products, why isn't it *more* likely that the wise man would work for a corporation?

In addition to relieving the epistemic burden on marketplace decision makers, the exit option is responsible for the greater creativity and energy that, as I noted earlier, can be expected from voluntary communities. The dedication of community volunteers to the cause that has brought them together cannot (except by chance) be duplicated effectively in a democracy, because a democratic *polis* brings into the net of its "community" everyone who happens to live within certain geographical boundaries, not just those who want to cooperate to achieve an end. Now if, at least in part, what motivates community volunteers to participate in a community is the desire to achieve some goal, they are likely to drop out if their efforts fail. Thus, the exit option will help select for effective communities—again, without anyone being required to articulate, as an expert would, what it is about a given community that makes it effective.

Just as the exit option enables consumers to abandon bad cigarettes or silk dresses, and volunteers to abandon unsuccessful communities, foreclosing the exit option leads not only to the ugliness and ineptitude of democratic politics, but the ugliness and ineptitude of the ideal-typical bureaucracy. I have suggested that the reason for bureaucratic hierarchy and red tape is the need to control employees who are not necessarily motivated by agreement with the ends, means, and personnel of the organization—as they would be if it were a community association; and who do not necessarily find each of the tasks they are assigned relatively agreeable, as they would if they were hired for each task individually. Even though any kind of bureaucracy is going to depart from ideal-typical market relationships, however, an entrepreneur's passionate vision of how to improve on what the market already offers may lead her to want to hire people who share her vision and are more con-

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cerned with achieving it than with rule following. If, as seems possible, creatively engaged employees are preferable to time servers, then her selection of such employees—and her creation of a workplace in which they can flourish—will itself tend to be selected for by the market, since consumers will be able to respond to the positive feedback her product provides by buying more of it. In state bureaucracies (monopolies), by contrast, such passion cannot (except by chance) be duplicated, because it depends on the entrepreneur being able to choose personnel who will think of creative ways to implement her vision. Since what makes a state bureaucracy different from a private bureaucracy is the inability of its "consumers" to choose another "brand," it has no mechanism to select for passion and creativity in either its leader or her subordinates. If passion and creativity are, indeed, valuable in organizations, governments have no way of encouraging it. (On the other hand, if my speculation about the value of passion and creativity is incorrect, then the market will select for corporate bureaucracies that are as sclerotic as state bureaucracies, and no advantage would be gained by foreclosing the opportunity to choose among them.)

* * *

There is more than a whiff of functionalism in Weber's view of bureaucracy. "The Germans," he claimed, "perfected the rational, functional, and specialized bureaucratic organization of all forms of domination from factory to army to public administration"; and World War I would mean "the world-wide triumph of this form of life, which was advancing at any rate" (Weber 1978, 1400).

Yes, bureaucracy seems to be everywhere; yes, that may indicate that it has a function; but does it follow that its function is unrivalled efficiency? Or might its function, instead, be simply that it is a way to keep a lid on employees who would otherwise be unruly because they have been hired (whether by a capitalist or a politician) to do work about which they are not particularly enthusiastic? In that case, bureaucracy would be a function not of its rationality, but of the quantity of uninspiring work to be done. If that quantity diminishes, so will the need for bureaucracy.

In the meantime, we should not mistake the omnipresence of bureaucracy for its rationality, or equate the advantages of marketplace bureaucracies with those of bureaucratically dominated states. Any form of interaction—from bureaucracies to markets to communities to personal relationships—that is left standing once unhappy participants can leave

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will, by virtue of surviving the exit test, have proven itself at least relatively (and temporarily) effective in binding people together in pursuit of some goal. If we assume that people tend to gravitate toward relationships that (for reasons they need not understand) make them happy, there would seem to be good reason to doubt that, other things being equal, organizations that specialize in coercion will be any more efficient in their output than they are satisfying in the eyes of their participants.

NOTES

1. I am using the term "intrinsic rationality" (Weber's "value-rationality") loosely, to indicate that participation in a relationship is valuable because it is fun, rewarding, or otherwise pleasant. Strictly speaking, pleasant actions are valuable not in themselves, but as a means to the end of happiness. But in familial, communal, and market relationships (as opposed to romantic relationships and friendships), the pleasure that may be what is truly valued by the participants is often not the end toward which the relationship is supposed to be instrumental. I loosely refer to the pleasure that may actually motivate people to participate in such relationships as "intrinsically" valuable so as to distinguish the real goal served by their participation from the ostensible goal.
2. Even persuasion requires a power relationship, since if one did not value one's interlocutor—if only for the truths he might have to offer—one would not converse with him. This gives him the power to withdraw from the conversation if he does not like how you are conducting your end of it—a coercive possibility that, to some extent (depending on how much you value his insight), gives him the ability to shape your behavior.
3. See n1 above.
4. See Friedman 1997, 430.

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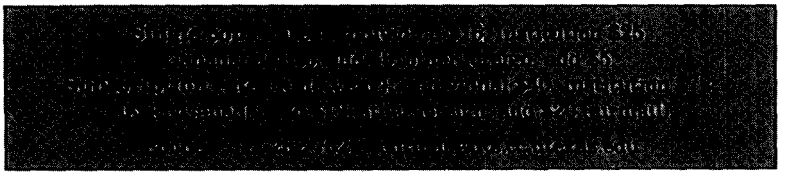

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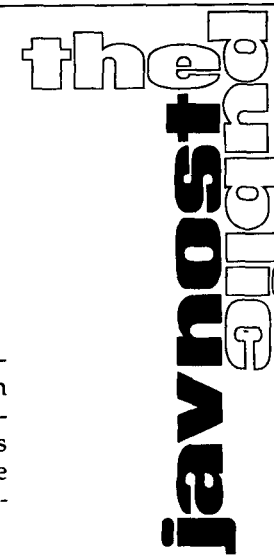

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